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## GENERAL REPORT

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# 1. Introduction

## 1.1. The subject of the IFA branch reports and the general report

The subject of this general report and the accompanying IFA branch reports is the tax consequences for both creditor and debtor of the restructuring of indebtedness.

The reports focus on the tax aspects for corporate debtors subject to normal corporate tax. Creditors may be corporate creditors (including financial institutions) and private individual creditors (e.g. portfolio investors, including holders of publicly issued bonds), although the focus is on corporate creditors. It is generally assumed that corporate debtors and creditors report profits on an accrual basis.

The reports aim to provide an overview of the domestic tax systems of the branches' jurisdictions and to consider whether these systems are balanced in terms of the overall debtor and creditor position, both in domestic and cross-border situations.

The branch reports were prepared based on directives issued by the general reporter. Branch reporters were requested to follow, where useful, the suggestions of the directives, in order to increase the comparability of the branch reports. In total, 29 reports were received<sup>1</sup> on this basis. In addition to the reports, branch reporters were also asked to answer a questionnaire. Some reports are accompanied by a separate summary on indirect tax issues related to the subject.

## 1.2. Context

In the 1990s, when the economic outlook was good and optimism reigned in the business communities of the world, substantial sums were borrowed to make acquisitions and new investments. The sky was the limit. High indebtedness was incurred on the basis of high profit forecasts for new types of business, although many only produced low-margin profits or were still making a loss. Borrowings came from public bond issues and from commercial banks.

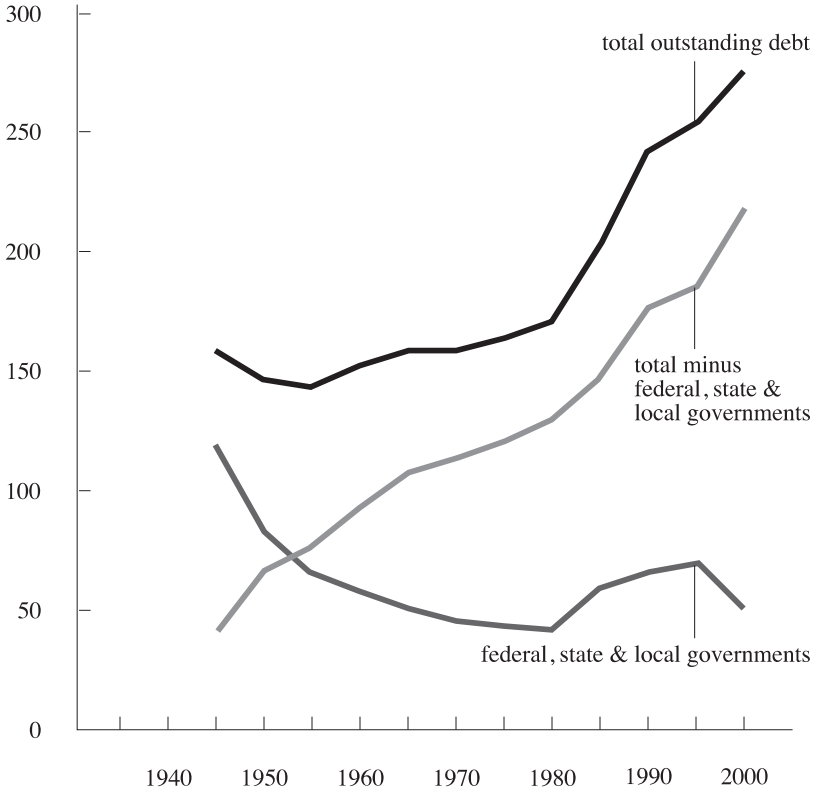
Figures 1 and 2 show the increase in external (corporate) debt in the US<sup>2</sup> and recent developments in the global debt capital markets.<sup>3</sup> Figure 2 illustrates that probably because of the recent revival of the economy and the substantial increase in merger and acquisition (M&A) transactions, global debt levels are rising again.<sup>4</sup>

<sup>1</sup> Argentina, Australia, Austria, Brazil, Canada, Chile, Denmark, Finland, France, Germany, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Peru, South Africa, Spain, Sri Lanka, Sweden, Switzerland, the United Kingdom, the United States and Uruguay. Reference in footnotes to a country name, followed by a number, are references to the branch report and the section number in that report.

<sup>2</sup> Annex to Magdoff and Foster. Author references in the footnotes refer to the bibliography.

<sup>3</sup> *The Financial Times*, 30 December 2005.

<sup>4</sup> Detailed statistical information on a country-by-country basis is available from The World Bank, on [www.worldbank.org](http://www.worldbank.org) under QEDS (Quarterly External Debt Statistics).



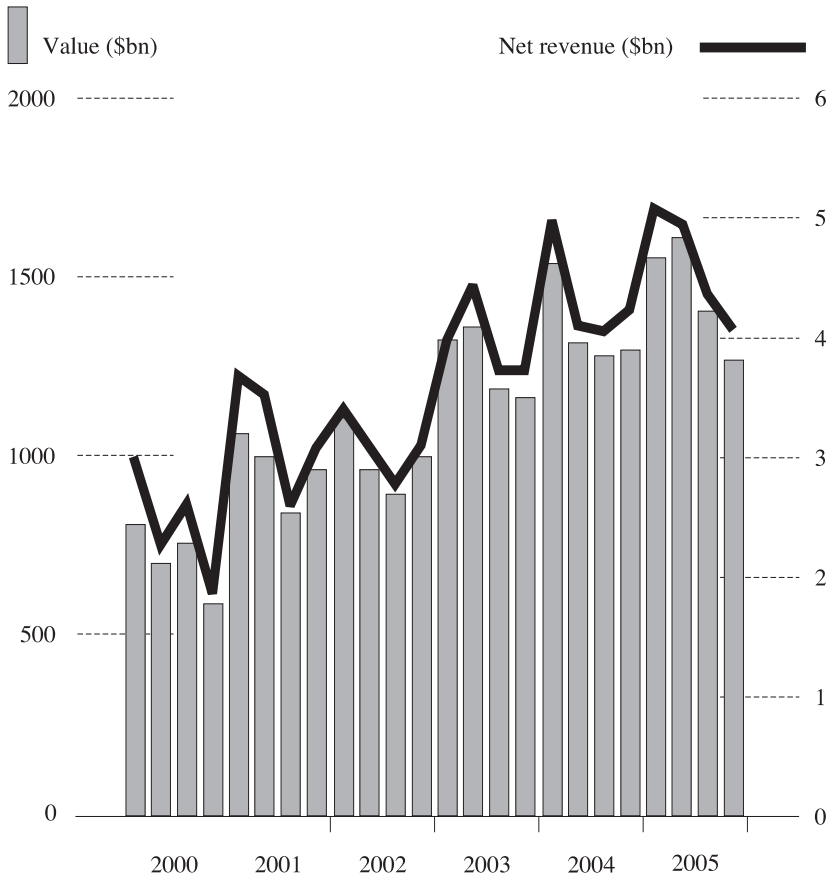
**Figure 1. Debt as a percentage of gross domestic product (GDP)**

Source: Debt data in charts calculated from data in Flow of Funds Accounts of the United States, Annual Flows and Outstandings. Board of Governors of the Federal Reserve System (Table L1). GDP is from US Department of Commerce, *Survey of Current Business*, August 2001

Substantial borrowings were pushed down to subsidiary levels, creating large intra-group loan relationships. Alternatively, subsidiaries borrowed funds directly but under group guarantees or secured by assets of related parties. Both scenarios created substantial related-party financial transactions.

Until recently, the world has been struggling with a recession. Various factors have caused numerous enterprises to experience financial difficulties. There was the general global economic downturn but there were also problems in specific sectors (for example, the bursting of the dotcom bubble, huge investments in UMTS in the telecom sector and the race to the bottom in air fares) and in specific regions (e.g. the east Asia and Argentina financial crises).<sup>5</sup> Financial scandals also brought large companies down, taking smaller dependent enterprises down with them.

<sup>5</sup> See for a summary of regional crises, Stone, Table 1.



**Figure 2. Global debt capital markets**

*Source:* Dealogic FT montage

Unable to service their debt, many companies had to try and make agreements with their creditors, face forced debt recovery or even bankruptcy.

Global statistical data on debt restructuring appear not to be publicly available, but given the number of cases mentioned in the financial press and the amount of debt reportedly involved, substantial amounts should be involved in this restructuring.

Nation-wide or region-wide financial crises may require governments to become involved and take action because of the possible catastrophic macroeconomic effects. Such action may involve removing legal barriers to economically desirable corporate restructuring, which may also mean removing tax barriers. From a number of branch reports it appears that governments have already taken legislative action in the tax area to remove tax impediments to successful restructuring.

### 1.3. From defaulting debt to debt work-out

The directives to the branch reporters suggested that they look at developments in the relationship between debtor and creditor, starting with a normal non-defaulting loan relationship, through the debtor's default, leading to a debt restructuring situation and, in a worst case scenario, bankruptcy. The most commonly used debt restructuring scenarios that the branch reporters were asked to consider are summarized in this section.

When a company's cashflow turns out to be substantially lower than expected, it will generally have difficulties servicing its debt. It starts to default on its interest payments and is unable to repay the principal when loans are terminated early (this is referred to as "debtor unable to service the debt"). Late payment interest may then become due, either through existing agreements or by law, and it is also possible that the interest rate on the debt instrument may be increased through a trigger mechanism.

When the core of a debtor's underlying business is in essence believed to be economically sound and the difficulties of the borrower are mainly liquidity related, it makes sense to try to prevent bankruptcy by restructuring the debtor's balance sheet. Debtors will attempt to raise new money in equity or new debt form, ceasing loss-making activities or selling non-core business activities.

When that is not possible or insufficient, they will need the cooperation of their creditors. For creditors it may be more attractive to renegotiate with the debtor than to force it into full repayment and risk a bankruptcy/foreclosure with a low pay-out ratio. Bankruptcy and forced liquidation of the debtor rarely extract maximum value, especially if the underlying business is promising, but heavily over-indebted, and markets are perceived to be only temporarily weak. Voluntary out-of-court restructuring schemes can then be attempted, involving a restructuring of the distressed company's indebtedness. Alternatively, forced in-court restructurings will be initiated. These may be needed if there are a large number of trade (unsecured) creditors and it is expected that it will be difficult to achieve unanimity among creditors.

Based on the lessons learned in various financial crises, the financial industry has developed informal principles of conduct for creditors in debt restructurings, the purpose of which is to arrange orderly, fair and future-focused debt work-out processes. Large debt work-outs often follow these principles. One example of this approach is the London approach, which was originally UK focused but was later also applied in multinational situations. Local variations on the London approach were used for local or regional debt crises.

In 2000 the INSOL principles were agreed.<sup>6</sup> The common denominator of these various codes of conduct is that they favour a going concern solution with temporary standstill, well-organized consultations between creditors and debtor leading to a long-term solution, fair to all interested parties, preferably negotiated and executed outside judicial procedures.

These debt restructurings will usually involve an amendment to the terms and conditions of the existing debt ("amendment of terms and conditions").

These amendments could (*inter alia*) consist of:

<sup>6</sup> Buljevich, pp. 6–26.

- (a) postponement of interest payments, without the accrued interest becoming interest bearing;
- (b) capitalization of interest payments, which are added to the principal and become interest bearing;
- (c) postponement of agreed principal repayment dates or extension of the final maturity date;
- (d) payment of interest or principal to be linked to the debtor realizing a (distributable) profit;
- (e) the debt becoming subordinated (in some jurisdictions this is a well-established way to prevent a debtor from having to initiate an insolvency procedure);<sup>7</sup>
- (f) additional collateral or security to be provided by the debtor;
- (g) adding of a right to convert the loan into equity of the debtor; or
- (h) any of the above whether or not in combination with an amendment of the interest rate to reflect the higher risk profile.

In a typical “rescue” scenario, a debtor’s shareholder and/or (a consortium of) banks would assist the defaulting debtor. External debt could be assumed by a related party against indebtedness by the debtor to the related party.<sup>8</sup> The proceeds of the new debt are used to repay the defaulting debt (“refinancing of debt by new debt”) and often also to provide additional working capital to allow the debtor to continue its business.

The debtor may enter into a new debt arrangement with the existing creditors replacing the existing debt (novation). This may involve refinancing by way of convertible debt (or debt with warrants attached), in order to give the creditors some future potential upside benefit should the debtor’s financial position improve. Alternatively, the debtor may agree with the creditors to provide equity instruments in the debtor in return for the cancellation of the debt and/or any amount of accrued interest (“conversion of debt into equity of the debtor”).

The creditor may agree to waive the debt (wholly or partially) or interest due, without any consideration (“waiver of debt”). A “partial waiver” in this sense may also be considered as a transfer of assets in full satisfaction of debt when the fair market value of these assets is lower than the principal amount of the debt. The same applies to a buy-back of outstanding debt or debentures (e.g. bonds) for an amount below the principal value with full cancellation of the debt.

If these debt work-outs fail, then the debtor may have to seek legal protection against its creditors by requesting a court-approved suspension of payment scheme or payment moratorium. In a worst-case scenario, a court will order the liquidation of the debtor’s assets for distribution to creditors (“suspension of payment and bankruptcy of the debtor”).

As a separate type of transaction, the creditor may assign the receivable on the debtor to another party. If that other party is related to the debtor, this type of transaction is often referred to as “debt parking”.

Some branch reports mention other forms of restructuring, such as mergers, demergers and some other specific forms often considered in domestic restructurings.

<sup>7</sup> E.g. Germany (*Rangrücktritt*); 3.2.2.

<sup>8</sup> Including a (related) party accepting joint and several liability for the debtor’s obligations with a right of recourse to the original debtor.

These are not discussed here because the tax consequences are generally very jurisdiction specific.

### 1.4. Terminology

Debt restructuring is the generic term describing the process irrespective of the cause of the restructuring or the way in which it is achieved. The term “debt work-out” suggests debt restructuring with a certain level of cooperation by (some) creditors, although it may also occur in a settlement reached during a procedure led by a court-appointed trustee or administrator.

The term “debt restructuring” should be interpreted in the widest possible sense and includes not only forgiveness of debt, but also debt-for-debt and debt-for-equity exchanges and local variants. The term “waiver” is considered a synonym for cancellation of debt (COD), debt forgiveness, release and discharge of debts, and these terms are used interchangeably in the general and the branch reports, unless stated otherwise. The same applies to debt-to-equity conversion and debt–equity swaps (DES).

In the reports, “debt” should be interpreted in the widest sense, unless stated otherwise. It may include loans, amounts owed under current account arrangements, trade debt and other types of payables. It can refer not only to both private debt (bank debt, inter-company debt) and publicly issued debt (e.g. bonds), but also the obligations under, for example, silent partnerships that are treated as debt for tax purposes. Sovereign debt (government bonds) restructurings are not discussed. When talking about the creditor’s position, generally the term “loan” is used; this is meant as the mirror image of “debt”.

All corporate taxpayers whose results are consolidated with the results of other related parties through mechanisms such as fiscal unity, tax consolidation, consolidated tax returns or tax groupings are referred to as (members of) a tax group in this report.

The term “related party” is used here in a generic sense without a concrete definition. From the reports, it transpires that the required relationship between parties for tax purposes differs per jurisdiction.

## 2. Indirect tax aspects

The focus of this subject is on corporate income and withholding taxes. If indirect taxes are also involved (e.g. value added tax – VAT, sales taxes, stamp duty and capital contribution taxes), and these taxes are a substantive factor in debt restructurings, this will be briefly mentioned in the reports.

It is generally assumed that the transactions discussed in the reports with respect to debts will not attract any VAT, sales or similar tax; if this is not correct in a specific jurisdiction<sup>9</sup> the reports should detail this to the extent that it could materially influence (the form of) the transaction.

<sup>9</sup> For instance in Argentina, loans are treated as an import of financial services, subject to VAT and provincial turnover tax (1.6); interest may be subject to Mexican VAT, but debt work-outs as such are not affected.

Under EU law, when a party professionally purchases debt claims, takes over credit risk and does so against a fee or commission, it may provide a service (factoring and/or collection services) that is taxable for VAT purposes.<sup>10</sup> This type of service is, however, not further discussed in the reports.

When trade debt is involved, VAT may be included. If the customer remains unwilling or unable to pay, some tax systems provide for a refund procedure<sup>11</sup> (or the tax not collected may be deducted as input tax by the creditor).<sup>12</sup> Generally, the creditor should prove that the debtor has not paid the VAT charged to it and that the creditor has attempted to collect this tax. The level of proof differs. In some jurisdictions sufficient effort to collect should be evidenced, for instance by reminder letters, etc.; in other jurisdictions legal collection procedures must have started and failed to produce a result; in other countries, the general insolvency of the debtor should be shown.<sup>13</sup> Similarly, the debtor will have to repay input tax if it does not pay the invoice on which this VAT was charged; the conditions under which this is required also differ.<sup>14</sup>

Some branch reporters have provided further details of any indirect tax issues that may have material effect in a short addendum to the report.

### 3. General issues

#### 3.1. Source materials on cross-border debt restructurings

Given the numerous debt restructurings that have taken place in the last decade, one would expect that the tax aspects of these types of operation would have attracted substantial attention in tax literature and tax policy discussions. That is clearly the case on the domestic level. Many articles are available on the subject in many jurisdictions. However, on the cross-border aspects, it appears that so far less attention has been given to the tax aspects.<sup>15</sup>

The OECD has been silent on the subject. The commentary to the OECD model tax convention (MTC) does not contain relevant language on the subject. In certain debt restructuring situations between related parties article 9(2) MTC could possibly be applied to remedy cases of double economic taxation.

On the non-tax side, there is some interesting literature on cross-border debt restructuring,<sup>16</sup> mostly discussing the financial techniques involved, comparing US Chapter 11 bankruptcy reorganizations with similar rules in other jurisdictions

<sup>10</sup> European Court of Justice, 26 June 2003, C-305/01, *MKG-Kraftfahrzeuge-Factoring GmbH*.

<sup>11</sup> The Sixth EU Directive on VAT (17 May 1977, 77/388/EEC) provides in art. 11C(1) for general principles, leaving quite some room for Member States in their implementation.

<sup>12</sup> Norway, 5.8.

<sup>13</sup> E.g. Spain, 5.1.

<sup>14</sup> E.g. South Africa: a delay in payment for 12 months in relation to a taxable supply of goods or services may trigger a recapture of input tax. When the debt is finally paid, input tax can again be deducted (6.1).

<sup>15</sup> There is a series of articles published in *Tax Management International Forum's* magazine (2003) and in *Derivatives and Financial Instruments* (2005), IBFD. See the bibliography for details.

<sup>16</sup> See the bibliography for details.

and discussing lessons learned in the financial area from particular restructurings such as those in Asia and Argentina. There is also considerable literature available on sovereign debt restructuring, which is generally not relevant for the subject at hand.

### **3.2. Qualification and related-party issues**

#### *3.2.1. Introduction*

A number of questions need to be answered to determine the applicable tax regime.

#### *3.2.2. Requalification issues*

Generally, before the tax impact of a tax restructuring is considered, one has to decide whether a debt instrument must be considered as (quasi-) equity for tax purposes. In the latter case, a different regime could apply and a substantial number of debtor issues mentioned below would normally not be relevant. Requalification of debt into equity may, among other things, be caused by:

- (a) the terms of the debt instrument: e.g. hybrid debt:<sup>17</sup> a statutory requalification rule based on type of remuneration (e.g. profit dependent), subordination and/or specific equity features;
- (b) thin capitalization rules that treat excess debt for tax purposes as equity;
- (c) the (non-arm's length) circumstances under which the debt instrument was granted between related parties; and/or
- (d) generic concepts of economic substance prevailing over legal form.

In some countries, the instrument itself is requalified; other jurisdictions focus on the requalification of the income.

From the branch reports, it is clear that there is no harmonization of these issues. A substantial number of different systems are applied. There are also countries where a strictly legalistic approach is taken and consequently these issues do not apply at all.

#### *3.2.3. Related parties*

Most tax regimes require that related parties deal with each other at arm's length and allow the tax authorities to correct profits if related parties have not acted on such terms.<sup>18</sup> In some jurisdictions these amendments can only be made in cross-border situations. Article 9(1) MTC allows profit correction in an arm's length situation. The language appears to be wide enough to allow requalification of debt for cross-border transfer pricing purposes.

The criteria for being considered related parties are not harmonized either. Article 9(1) MTC mentions in general terms a direct or indirect participation in

<sup>17</sup> See also *Cahiers*, 2000, vol. 85a, *Tax treatment of hybrid financial instruments in cross-border transactions*.

<sup>18</sup> Some countries do not apply transfer pricing rules based on arm's length corrections in domestic situations but apply value shifting rules instead, leading to tax cost base shifting and capital gains tax consequences.

management, control or capital. In the countries under review the tests clearly differ substantially: there are formal control tests (more than 50 per cent shareholding and/or management involvement), but also more material control tests in combination with formal tests (e.g. interest in value and/or profits). Some regimes apply quite low minimum shareholding tests.<sup>19</sup>

In some tax regimes, a loan provided by an external party may also be treated as related-party debt if the loan is secured on the assets of parties related to the debtor (e.g. securities granted by a related party, parental guarantee, etc.).

There are basically two types of approach that the countries under review take to related-party debt:

- (a) The arm's length standard is applied to the granting of the loan itself: requalification into equity may occur if under arm's length conditions the loan would not have been granted by an unrelated party on the same terms and conditions. In that case, debt work-outs between related parties are also tested on an arm's length basis. A work-out between related parties is treated in the same way as between unrelated parties if the related parties have acted at arm's length.
- (b) The other approach is having specific statutory rules for financial relations between related parties. This, for example, is the case in Brazil, Denmark, Finland and the UK. In that case, the arm's length test is overridden by those rules. The motivation is generally to combat abuse on the creditor side.

#### *3.2.4. Debtor and creditor member of same tax group*

Generally, if the debtor and creditor are part of the same tax group, a debt restructuring does not have direct tax effect, because it happens within the consolidated tax group. However, for certain purposes, members of the group may have to calculate taxable profit on a stand-alone basis and in those situations, a debt restructuring within such a tax group may have indirect tax effects.<sup>20</sup>

### **3.3. Impact of accounting standards**

In some jurisdictions, where tax accounting is substantially based on commercial accounting, qualification issues and/or valuation issues in the tax field are influenced by local generally accepted accounting principles (GAAP). Local GAAP may contain specific rules that are, directly or indirectly, relevant for debt restructuring.<sup>21</sup>

Increasingly International Accounting Standards (IAS) have become relevant. In some countries IAS have already found their way into regional and/or domestic accounting rules.<sup>22</sup> Currently, the use of IAS is obligatory, mainly in

<sup>19</sup> E.g. Finland: already at 10 per cent shareholding in relation to non-deductibility of losses on related debtors (3.2.1).

<sup>20</sup> E.g. the US, 2.6.

<sup>21</sup> As an example: US Statement of Financial Accounting Standards no. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings* and no. 114, *Accounting for Creditors for Impairment of a Loan*.

<sup>22</sup> Notably the European Economic Area, requiring obligatory use of IAS adopted by the European Commission as per 1 January 2005 (subject to certain deferral options) in consolidated accounts

consolidated accounts of publicly traded companies. However, in some jurisdictions using IAS in annual accounts is either optional or even already obligatory. If tax accounting relies on commercial accounting, these standards may then affect the tax qualification and the tax valuation of instruments as well as the realization of profits.<sup>23</sup>

From the branch reports it appears that IAS already affect the tax consequences of debt restructuring in Belgium,<sup>24</sup> Italy<sup>25</sup> and the UK.<sup>26</sup>

## 4. Debtor issues

### 4.1. General

Important points to consider for debtors are interest deductibility and interest withholding tax. In this context thin capitalization rules may also come into play.

In some jurisdictions interest is deductible only if incurred for – generally – business purposes. In the reports, it is generally assumed that interest due under the debt in question is deductible for tax purposes. A detailed discussion of general interest deductibility rules and withholding tax rules would be outside the scope of the reports.

### 4.2. Debtor unable to service the debt

If the debtor is unable to service the debt as agreed, the first effect is normally that the debtor defaults on an interest payment. Subsequently, it may miss a repayment obligation and cross-default clauses may be triggered on other debt.

In related-party situations, if a debt is not serviced properly and parties do not address the inability of the debtor to service debt in the same manner that unre-

*cont.*

of publicly traded companies as per Regulation (EC) no. 1606/2002, OJ L243, 11 September 2002. Pursuant to this regulation, Member States may permit or require usage of IAS for annual accounts of said companies and/or for other companies. In some jurisdictions, use of IAS in annual accounts is required, in some it is optional. See for a table of Member States of the European Economic Area intending to use the options granted by the regulation: [http://europa.eu.int/comm/internal\\_market/accounting/docs/ias/ias-use-of-options\\_en.pdf](http://europa.eu.int/comm/internal_market/accounting/docs/ias/ias-use-of-options_en.pdf).

<sup>23</sup> Relevant standards in this respect are: IAS 32 (*Financial Instruments: Disclosure and Presentation*), to be replaced effective 1 January 2007 by IFRS 7, *Financial Instruments: Disclosures*), IAS 39 (*Financial Instruments: Recognition and Measurement*) and, indirectly, IAS 36 (*Impairment of Assets*) and IAS 37 (*Provisions, Contingent Liabilities and Contingent Assets*). IAS 30 (*Disclosures in Financial Statements of Banks and Similar Financial Institutions*) is relevant for banks, but in substance refers to IAS 32 and 39 in relation to the subject of this report. IAS 36 does not apply to financial instruments, but some of its principles are relevant to the subject at hand. IAS 37 does not apply to financial instruments carried at market value, but does apply to financial instruments carried at amortised costs.

<sup>24</sup> Lamon and Chalot, p. 279.

<sup>25</sup> Italy, 3.3 (tax treatment of convertible bonds) and 5.7 (assignment of loan with credit risk staying behind with the seller).

<sup>26</sup> UK, 1.

lated parties would do, this may be seen as an indication that the debt was not established in an arm's length manner and this may (retroactively) have consequences for the qualification.<sup>27</sup>

#### 4.2.1. *Interest deduction continued?*

If the debtor is unable to pay, can it nevertheless continue to deduct interest on the debt?

In most jurisdictions this is the case; unpaid interest remains contractually due even when unpaid. The ability to pay is generally irrelevant to deductibility and interest can continue to be booked on an accrual basis.

If the debtor's financial position is close to the application of any thin capitalization ratios, then the accrual of interest may push it over those limits and as a result some of the interest may not be deductible.

There are exceptions, in that some regimes have statutory rules limiting deductibility of interest not actually paid and carried over from a previous year.<sup>28</sup> Italy uses a cash-based system for delayed interest<sup>29</sup> and Mexico for penalty interest.<sup>30</sup> Sri Lanka requires taxpayers to amend their previous tax return if accrued interest is not actually paid within three years.<sup>31</sup> In the UK interest deductibility is deferred until actual payment if the interest due remains unpaid for at least 12 months if the debtor and creditor are related to each other.<sup>32</sup> In South Africa, under common law rules, interest in principle stops accruing if the unpaid amount of interest due equals the amount of the principal debt.<sup>33</sup>

In some jurisdictions there is case law that prohibits further deduction of interest and may also lead to recognition of profit for the total of accrued interest and principal if it has become highly improbable that the principal amount of the debt and the accrued interest will ever be actually paid.<sup>34</sup>

#### 4.2.2. *Withholding tax on interest*

In jurisdictions that levy a withholding tax on interest the question arises whether the debtor is required to continue to pay withholding tax to its tax authorities even if the interest is no longer paid.

Most jurisdictions require the payment of withholding tax only when the interest is actually paid.<sup>35</sup> However, some jurisdictions require this at the time the interest is contractually due<sup>36</sup> or at the time of the mere accounting of the interest by the debtor.<sup>37</sup>

<sup>27</sup> E.g. US, 3.1.2.

<sup>28</sup> Argentina, 3.2; Denmark, 3.2; India, 3.1.

<sup>29</sup> 3.1.

<sup>30</sup> 3.1.

<sup>31</sup> 3.1.

<sup>32</sup> 3.1.

<sup>33</sup> South Africa, 3.1.

<sup>34</sup> The Netherlands, 3.2; similar rules exist in the US where there is no reasonable possibility that the interest will ever be paid; US, 3.1.1.

<sup>35</sup> E.g. Canada, Chile, France Germany, the UK and the US.

<sup>36</sup> E.g. Belgium, Indonesia, Mexico, Spain and Switzerland.

<sup>37</sup> Brazil (although this is challenged), 3.1 and Peru.

In cross-border situations, the question can be asked whether the anti-deferral rules can be applied under the MTC now that article 11(1) of the model refers to interest “paid”. According to paragraph 5 of the commentary “The term ‘paid’ has a very wide meaning, since the concept of payment means the fulfilment of the obligation to put funds at the disposal of the creditor in the manner required by contract or by custom.” The commentary clearly relates to actions of the debtor and in the situation at hand the problem is that the debtor is not paying, although being obliged to do so.

However, the commentary in paragraph 9 states that article 11(2) allows the source state to apply its own laws in terms of the way in which the tax allowed by article 11(2) is levied. This suggests that the MTC does not prohibit the source state from levying a withholding tax from the debtor when the interest is contractually due. Logically, in determining the amount of the tax due, the source state should use the tax treaty that applied at the time interest was due, based on the state of residence of the creditor. Although the creditor would not receive any interest, it would still have to comply with any treaty formalities, if any, at that point in time. If it did not, the debtor would have to withhold according to domestic legislation at the domestic rate. As a result, when the interest is actually paid, the debtor could be prevented from claiming a lower treaty rate based on statutes of limitations that apply to the relevant treaty.

In the case of a debt restructuring, where the relevant instrument, including unpaid but accrued interest, would be transferred to another party to whom the interest would finally be paid, the question of correct treaty application would arise. In this case the source state would require withholding at the time the interest was due and, as mentioned above, the treaty applicable to the old creditor would be applied.

This may be different for source states that require withholding at the time of actual payment of the interest. It seems logical to also apply the treaty that applied at that time between the debtor state and the state where the creditor then resides.

### *4.2.3. Penalty charges*

Penalty charges, applied either through contractual arrangements or by law, should normally<sup>38</sup> also be deductible for the debtor on an accrual basis. The last sentence of article 11(3) MTC specifically excludes penalty charges from the application of article 11, but the commentary in paragraph 22 leaves contracting states the freedom to omit this exclusion from bilateral treaties and treat penalty charges as interest for treaty purposes.<sup>39</sup>

## **4.3. Amendment of terms and conditions**

### *4.3.1. General*

Amendment of terms and conditions may lead to:

<sup>38</sup> See for exceptions examples mentioned in section 4.2.1.

<sup>39</sup> France, 1.1.

- (a) no tax consequences whatsoever; in some countries modification of the terms and conditions of a debt does not lead to any tax effects if the debtor and creditor remain unchanged; or
- (b) specific tax consequences depending on the amendment; or
- (c) a deemed novation of the debt.

If the amendment leads to profit recognition for the debtor, this profit would not be taxable in some countries, under specific related-party regimes.

#### 4.3.2. *Specific tax consequences*

As a general comment, any amendment of terms and conditions may lead to the revisiting of requalification issues as outlined above, and it may trigger stamp tax.<sup>40</sup>

Postponement of interest payments will generally have the effects discussed in section 4.2 on outstanding unpaid interest. In New Zealand the interest due, if not interest bearing, may lead to recapture of interest deducted in earlier years.<sup>41</sup> According to the German tax administration, postponing interest payments in related-party situations may cause the remuneration of the debt to be deemed profit dependent, leading to non-deductibility of the interest.<sup>42</sup>

In general, making the interest profit dependent may lead to requalification and consequently interest deductibility (and possibly dividend withholding tax) issues.<sup>43</sup> This would normally not apply when the interest remained at a fixed rate but the payment of it was made dependent upon the debtor realizing a profit or distributing a profit.<sup>44</sup>

The capitalization of interest will often be treated for withholding tax purposes as a payment of interest and this would trigger withholding tax and, in some jurisdictions, stamp tax<sup>45</sup> as well.

An increased interest rate to reflect higher risks, whether already built into the contract or amended after the initial debtor's default, would not normally lead to specific tax issues, if at arm's length. Generally, the new higher interest will be deductible. Some countries, however, disallow deduction of interest on bonds exceeding a certain standard market rate, irrespective of the solvency position of the debtor as well as in unrelated party situations.<sup>46</sup>

In related-party situations making the loan interest free will normally trigger an arm's length issue. If not, there are very likely to be valuation issues (the principal amount will decrease to a discounted amount and the difference may constitute a partial waiver). However, some jurisdictions (such as Indonesia) have specific rules in that respect which accept interest-free loans under specific conditions,<sup>47</sup> and Italy has specific thin capitalization rules for interest-free loans.<sup>48</sup>

<sup>40</sup> E.g. Chile (3.2) in some circumstances on the full amount of the principal.

<sup>41</sup> 3.2.

<sup>42</sup> 3.2.3.

<sup>43</sup> E.g. Mexico 3.2. and South Africa, 3.2.

<sup>44</sup> South Africa, 3.2. See also the Netherlands in certain circumstances (2.3).

<sup>45</sup> E.g. Argentina, 3.2 (withholding tax) and Chile, 3.2 (stamp tax on capitalized interest).

<sup>46</sup> E.g. Italy, 3.2.

<sup>47</sup> 2.

<sup>48</sup> 3.3.

In some jurisdictions modifying the terms and conditions may mean the interest withholding tax exemption is no longer applicable.<sup>49</sup> If the agreement contains a gross-up clause, the costs associated with it lie with the already troubled debtor.

Postponing the ultimate repayment date of the principal amount may again lead to requalification issues for the instrument itself, because a statutory threshold is crossed or an earlier economic analysis leads to a different outcome. The requalification may even have a retroactive effect.<sup>50</sup>

In Germany there is some sensitivity in making a debt subordinated. There is a risk that the debt may no longer be recognized as such if it does not meet certain requirements imposed by the German tax authorities.<sup>51</sup>

As a more general point, when the debtor's obligation decreases in value due to any amendment of the terms and conditions, in some jurisdictions this is treated as a (partial) waiver. This appears to be a particularly sensitive issue in Sweden.<sup>52</sup> In the US detailed rules exist to calculate COD income for the debtor when old debt is exchanged for new debt, either through significant debt modification or through actual novation. COD income is in principle taxable for the debtor.<sup>53</sup> In the UK if, under IAS rules, the valuation of debt changes, this will have tax effects.<sup>54</sup>

### *4.3.3. Deemed novation*

Debt modification between the same parties may have potentially material tax effects if the terms and conditions are amended in such a way that for tax purposes the debt is considered novated, even though from a legal perspective the principal amount of the debt remains in place.

In most countries, a material test is applied based on case law, without a defined statutory threshold for what is considered a material amendment. For example, in Luxembourg, an economic analysis determines whether a debt is considered novated.<sup>55</sup> In other jurisdictions, more detailed guidance is available or even specific rules apply.<sup>56</sup> The consequences of deemed novation are further discussed in the next section.

## **4.4. Refinancing the debt by new debt**

### *4.4.1. Types of transaction*

Refinancing of the old debt by new debt can be achieved in a number of ways. The old debt can be novated between the same debtor and creditor, with amended

<sup>49</sup> E.g. Canada, 3.3 and 6.2.

<sup>50</sup> The Netherlands, 3.2. In Australia, extension of the maturity may cause a debt to fall into another category, resulting in other criteria for deductibility becoming applicable (3.2).

<sup>51</sup> 3.2.2.

<sup>52</sup> 3.2.

<sup>53</sup> Cancellation of debt (3.2.3).

<sup>54</sup> 3.2.

<sup>55</sup> 3.2.

<sup>56</sup> See, for example, the Canadian guidance on material modifications (3.2); see also detailed US rules for significant debt modification (3.2). Such a modification triggers a deemed exchange for new debt.

terms and conditions and/or with a new principal amount to provide the debtor with additional working capital.

The debtor could borrow funds from a new creditor and use the proceeds of the new loan to repay the old debt. In a rescue scenario, typically shareholders and/or (a consortium of) banks would come to the assistance of the defaulting debtor. In addition, the assumption of (often external) debt by a related party against indebtedness to the related party falls under this heading.

#### 4.4.2. *Consequences for old debt*

These types of transaction are generally treated in the same way as a regular repayment of the old debt would be treated. An unrealized currency exchange result will often be realized.

When the old debt is repurchased for an amount exceeding its book value, the debtor could realize a loss. This is for instance the case in the US if either the old debt or the new replacing debt is publicly traded.<sup>57</sup>

When the new debt has a value lower than the old debt, the difference in value may be treated as a (partial) waiver leading to a potential profit for the debtor. This may be particularly sensitive in the UK through its reliance on IAS accounting standards; however, a result realized on the old debt may not be tax effective if realized in a related-party situation.<sup>58</sup>

In countries that levy a withholding tax, the novation may trigger accelerated withholding tax obligations on the amount of interest deemed paid under the old debt because of the novation.<sup>59</sup>

#### 4.4.3. *New debt*

On new debt, the normal rules for qualification apply.<sup>60</sup> This includes the application of arm's length tests if the debtor and (new) creditor are related. A new creditor may also lead to a new withholding tax situation.

(Deemed) novation may have particular consequences if the old debt benefited from transitory rules after a change of law and the new (deemed) debt is considered a new agreement falling under new legislative rules.<sup>61</sup> As regards withholding tax, domestic exemptions or treaty-based reductions may change.

Generally, absent specific statutory rules, new debt is tax-wise in the same position as the old debt, e.g. if interest deductibility is dependent upon the purpose of the loan and if the interest was deductible under the old debt, it generally will remain deductible under the new debt replacing the old debt.

Stamp duty may be due on the new debt.<sup>62</sup>

<sup>57</sup> 3.3.

<sup>58</sup> 3.3.

<sup>59</sup> E.g. Belgium: Lamon and Chalot, p. 284. Chile, 3.3.

<sup>60</sup> Although for instance in Australia, the characterization of the old debt rolls over into the new debt; Australia, 3.3.

<sup>61</sup> Australia, 3.2; also Brazil, 3.2, regarding denial of grandfathering of old loans benefiting from a withholding tax exemption.

<sup>62</sup> E.g. Austria, 3.3: 0.8 per cent; Chile: 2.

### *4.4.4. Exchange in convertible debt*

An alternative that is often contemplated in debt restructuring is the conversion of the debt into a convertible instrument or the issue of warrants. In most jurisdictions this does not lead to equity treatment until actual conversion/exercise.

## **4.5. Conversion of debt into equity of the debtor**

### *4.5.1. General*

If the instrument was already qualified as equity for tax purposes, the conversion into formal equity should normally be a non-event.<sup>63</sup>

A distinction can be made between conversion in the context of a debt restructuring and conversion based on a pre-existing conversion right. However, in most countries, the tax consequences are the same.

### *4.5.2. Form*

The usual scenario is that (excessive) debt needs to be removed from the debtor's balance sheet. The creditor accepts that regular debt service is no longer feasible but does not wish to give up all its rights; if the debtor manages to survive, the creditor would like to have its stake of the future profits.

There are many different ways of achieving this. If the creditor is already the sole shareholder of the debtor, a waiver will have the same economic effect. If the creditor is not yet a shareholder, or is a minority shareholder, a conversion into share capital may give it more control through the voting rights on the new shares issued to it.

Conversion can be achieved through issuing shares under the obligation to contribute capital, which is set off against the obligations by the debtor under the debt. Alternatively, a contribution in cash could be made on (new) shares and the cash subsequently used to repay the debt. In some countries it is usual to structure this as a release of debt for consideration of new shares. A debt-to-equity conversion can also occur based on a court-approved transaction that is binding upon minority shareholders and creditors.<sup>64</sup>

A (deemed) conversion may be considered to have taken place if the terms and conditions of a debt instrument are amended in such a way that for tax purposes the resulting situation is treated as equity.

### *4.5.3. Conversion at face value or at fair market value*

The key issue is whether the debtor should recognize taxable profit when a certain amount of debt is converted into nominal share capital of the debtor. The debtor would often record only a shift from debt to equity in its books for the same face value amount and no result would show.

<sup>63</sup> Sweden considers the conversion a non-event anyway (3.4).

<sup>64</sup> E. g. UK, scheme of arrangements, 3.4.

However, in these circumstances it is clear that the shares issued for the creditor will have a value below the face value of the debt. The creditor will then realize a loss upon the conversion, while the debtor, in face value terms, would not have a result. Therefore, the key question is from whose perspective the conversion is considered.

Corporate law and creditor protection rules have influenced this issue. Broadly speaking, under those rules the issue of new shares against a contribution in kind with a lower value than the nominal value of the shares issued is normally prohibited. Economically, however, the debtor is released from an obligation equalling the principal amount of the debt, so that creditors benefit from the conversion. Supreme Courts in various jurisdictions have come to different decisions and these decisions have clearly influenced the local tax treatment.

Some jurisdictions allow the debtor to convert, for tax purposes, the nominal amount of the indebtedness into the same nominal amount of share capital, disregarding the fair market value of the debt and the shares issued (“face value theory”).<sup>65</sup> Tax losses (and other tax attributes) of the debtor then normally remain unaffected, because no taxable profit is recognized. For instance, this is the case in Brazil, France, Japan, Mexico, the Netherlands, New Zealand and Peru.

Other jurisdictions consider the fair market value of the debt the contribution on the equity (“fair market value theory”): the difference then leads to profit realization for the debtor.<sup>66</sup> Australia treats the conversion as a (partial) forgiveness of a debt. The debtor credits its capital account only with the value of the shares issued.<sup>67</sup> Denmark treats the difference as a capital gain.<sup>68</sup> Korea provides an interesting middle solution, where the face value theory is applied to non-publicly traded shares, but the fair market value theory to publicly traded shares.<sup>69</sup>

In these fair market value theory jurisdictions, the difference between face value and fair market value is normally treated as a (partial) waiver.<sup>70</sup> So as not to hamper bona fide debt work-outs, in several jurisdictions the partial waiver may again benefit, under certain conditions, from specific exemptions or other special treatment. For example, this happens in the UK where a release of debt in consideration for shares in the debtor benefits from an exemption.<sup>71</sup> In the context of “lessons learned” some jurisdictions have changed back to the face value theory.<sup>72</sup>

<sup>65</sup> Term borrowed from the Japanese report. Face value theory versus fair market value theory; Japan, 3.4.1. The choice between these two theories has been the subject of tax case law in various jurisdictions, for example in Italy, Japan and the Netherlands.

<sup>66</sup> E.g. Austria, 3.4; Germany, 3.4; US: COD income results; US, 3.4.1.

<sup>67</sup> 3.4.

<sup>68</sup> 3.4.

<sup>69</sup> 3.4.

<sup>70</sup> See further section 4.6.

<sup>71</sup> 3.5.

<sup>72</sup> For example, although the Netherlands previously applied the face value theory, it taxed debtors from 2001 to 2005 on the difference between the fair market value of the debt and the nominal value of the debt in case of *de facto* or legal conversion of the debt into equity of the debtor. Because of negative impact on debt work-outs, these rules were abolished with some retroactive effect at the end of 2005.

The creditor could also inject cash on (new) share capital that the debtor uses to repay the principal of the debt. In some of the fair market value theory jurisdictions anti-abuse legislation assimilates this type of transaction with a straightforward debt-to-equity conversion, and consequently a deemed (partial) forgiveness is assumed.

#### *4.5.4. Creditor becoming related to debtor*

A previously unrelated creditor may become a related party to the debtor because of a debt-to-equity conversion. Generally, this has no direct impact on the debt restructuring itself, but may affect the debtor's tax position after the conversion.

If a jurisdiction has "stop loss" rules that are triggered by certain changes of ownership or control of the debtor, the debtor may lose previous losses.<sup>73</sup> In Japan losses may, for example, evaporate in the case of a conversion between 100 per cent group companies.<sup>74</sup> In the US a 50 per cent or more ownership change over any three-year period may trigger the loss of certain debtor's tax attributes.<sup>75</sup> Furthermore, in most other jurisdictions change of control rules affecting ongoing availability of loss carry-forwards may be triggered by substantial conversions.

#### *4.5.5. Other tax consequences*

For withholding tax purposes, interest due under the old debt may lead to interest deemed to have been paid upon conversion, so that withholding tax may be due.

Capital tax or stamp duties may be payable on the conversion. Since these taxes are generally levied on an *ad valorem* basis, the question is whether this tax is levied on the face value or on the fair market value of the debt that is contributed on the equity.<sup>76</sup> Both systems appear to be applied.

### **4.6. Waiver of debt (wholly or partially) or of interest due**

#### *4.6.1. Form of waiver*

A waiver generally involves a creditor explicitly informing the debtor that it no longer requires the debtor to meet its obligations under the debt. A waiver may be for the full or part amount of the outstanding debt, including unpaid but accrued interest. It may take the form of a unilateral binding statement or it could be in the form of an agreement. In arm's length circumstances, a creditor will probably only waive a debt to the extent that it believes it is entirely unlikely that a material amount will be paid on the debt and/or that the cost of achieving payment will exceed the likely proceeds.

<sup>73</sup> E.g. Finland, 3.1.4, although discretionary exemption can be obtained if this is necessary for the continuation of the debtors operations. The threshold for these stop loss rules to apply varies by jurisdiction. In some jurisdictions, change of control is required.

<sup>74</sup> 3.4.1.

<sup>75</sup> 3.4.2.

<sup>76</sup> E.g. Austria, 3.4.

In some jurisdictions there are also other forms of cancelling debt which are treated as a waiver, such as when collection of a debt becomes statute-barred;<sup>77</sup> also a creditor not taking any action to collect amounts legally due to it may after some time be considered to have waived the amount due.

In a fair few jurisdictions the instrument of a conditional waiver is known. This is essentially a waiver on the condition that if the debtor's financial position improves, the receivable of the creditor revives. This can be implemented through an agreement or through a specific security instrument issued by the debtor in consideration of the waiver.<sup>78</sup> Typically, for tax purposes, the waiver is treated at the time of the waiver as an unconditional waiver, both for the debtor and the creditor, and no value is attached to the revival instrument. When the condition for revival is met, the debtor and creditor must include the debt again in their balance sheet and record a cost/profit. In some jurisdictions only the actual payments made under the revival instrument are recognized for tax purposes.

A partial waiver may also occur if a creditor agrees to release the debtor for the full amount of its indebtedness against partial payment, either in cash or in kind (for instance by the transfer of certain assets that serve as security for its obligations).

Interestingly, in New Zealand a partial waiver may lead to the spreading out of the profit realized as a result of the waiver over the remaining years of the remaining debt, recognizing the waiver profit attributable to the period up to the time of the waiver.<sup>79</sup>

#### 4.6.2. Waiver between related parties

In related-party situations, the waiver is the more sensitive form of debt work-out, because it is often difficult to distinguish between bona fide business reasons and shareholder motives.

If shareholder motives have driven the waiver, it may be considered a deemed capital contribution for the debtor<sup>80</sup> instead of a profit and to that extent the losses of the debtor (and other tax attributes) usually remain unaffected.

Depending on the exact relationship between debtor and creditor, further capital contributions or deemed dividend distribution could be construed. These transactions may be subject to capital tax and/or dividend withholding tax or, in sister relations under the triangle theory,<sup>81</sup> a dividend distribution followed by a capital contribution could be construed.

The question is for what amount a capital contribution is considered if the fair market value of the debt is below the principal amount. Here again the differences between the face value and fair market value theory<sup>82</sup> show. In the face

<sup>77</sup> E.g. Australia, 3.5.

<sup>78</sup> E.g. Germany and Switzerland: *Besserungsschein* (3.6; recovery certificates). France: *retour à meilleure fortune* clause. Irrespective of the form, these types of conditional waivers are collectively referred to in this report as a "revival instrument".

<sup>79</sup> New Zealand, 3.5.

<sup>80</sup> E.g. Austria, the Netherlands and Switzerland.

<sup>81</sup> Switzerland, 5.5, but also the Netherlands.

<sup>82</sup> See section 4.5.3.

value theory, the whole amount of the debt is considered informal capital. In the fair market value theory, this applies only to the fair market value; the difference between the fair market value and the principal amount is treated as a profit for the debtor.<sup>83</sup>

In jurisdictions with related-party rules or within tax groups, the waiver by a creditor/related party may not have any material tax effect. In the UK, a waiver does not lead to a tax charge in certain related-party situations based on anti-abuse rules.<sup>84</sup>

Similar consequences may occur if a party related to the debtor agrees to take over the debtor's obligations without consideration from the debtor. In most cases it can be expected that this will be considered as a contribution of equity by the new obligor, directly or indirectly, into the debtor. If a creditor "parks" a debt with a lower fair market value than its face value with a party related to the debtor, this may also be considered a partial waiver (see section 4.8).

### 4.6.3. Other waivers

In most cases where the creditor is an unrelated party, or is a related party acting on an arm's length basis, the waiver will in principle lead to the recognition of a profit by the debtor for the debt from which it is released. In some jurisdictions, a waiver does not create taxable profit, but only reduces available tax attributes (such as carried forward losses, capital losses, asset base costs, foreign tax credits, etc.) of the debtor.<sup>85</sup>

Usually the debtor will have sufficient losses that are available for compensation. Often it is also possible for the debtor to impair business assets in the light of the financial crisis. In some jurisdictions that have a time limitation on the carry-forward of losses, the time limit is lifted in these circumstances so that older losses that would normally already have evaporated can also be used.<sup>86</sup> In other jurisdictions that apply a proportionate restriction to the use of previous year's losses the restriction may not apply in case of certain financial restructurings.<sup>87</sup>

South Africa makes a distinction between waiving accrued expenditure and the principal amount. A waiver of principal will result in a capital gain, which has a different treatment as ordinary income.<sup>88</sup>

Some jurisdictions allow an exemption of the profit caused by the waiver, often to the extent that the waiver exceeds the amount of the available losses. In effect, this means that the waiver eats up available tax losses and is otherwise exempt. This causes an asymmetry in the debtor-creditor tax treatment and results in an overall revenue loss for the government. This is usually motivated by the need to avoid economically valuable debt restructuring being hampered by a debtor having to find additional funds for an actual cash outflow to pay tax. The local government is then effectively subsidizing part of the debt restructuring through acceptance of this asymmetry.

<sup>83</sup> E.g. Germany, 3.5.2, Indonesia, 3.4 and US, 3.5.

<sup>84</sup> UK, 3.5 and 4.

<sup>85</sup> Australia, 3.5.

<sup>86</sup> E.g. Switzerland, 3.5.

<sup>87</sup> E.g. Austria, 3.5.1 (*Sanierungsgewinne*).

<sup>88</sup> 3.5.

An arm's length waiver normally does not lead to withholding tax consequences or stamp duty consequences.<sup>89</sup>

Particular reference must be made to the rather complex and sophisticated Canadian debt forgiveness rules that seem to combine most of the treatment mentioned above and add some new ways to deal with waived amounts. The forgiven amount first reduces the debtor's tax attributes in a specific order, partially mandatory, partially optional. Any remaining balance may be transferred to one or more related parties (where it can be compensated with certain tax attributes, if any). Any remaining balance must be included in the debtor's taxable income for 50 per cent, subject again to certain exceptions.<sup>90</sup> However, in order to prevent a debtor from becoming insolvent because of these debt forgiveness rules, the remaining forgiven amount that is to be included in the debtor's taxable income cannot exceed twice the debtor's net assets.

Denmark grants a full exemption if the waiver is part of a general arrangement (referring to the amount involved in the arrangement) with creditors. Otherwise the waiver is taxed, unless the creditor is related and has not taken a deduction against its own taxable profit (in that case the waiver is tax free for the debtor). Interestingly, in the case of a foreign creditor, the same applies as long as the foreign creditor would not have been entitled to a deduction under its own tax law and under specific Danish tax provisions, had it been subject to those provisions.<sup>91</sup>

Germany taxes profit realized as a result of a waiver in principle, but has some beneficial arrangements for financial restructuring. The profit realized may be compensated with all previous losses, disregarding the normally applicable limitations. The resulting profit is taxed, but the collection of that tax is, under certain conditions, first postponed and subsequently waived.<sup>92</sup>

Japan does not apply the carry-forward time limit in certain qualifying out-of-court reorganization procedures, allowing older losses to be applied against the profit of a debt waiver. However, this is subject to full revaluation of all assets and liabilities in some circumstances.<sup>93</sup>

In some other jurisdictions waivers are also exempt or benefit from other specific advantageous treatment if granted in a formal insolvency procedure (see further section 4.7.2).

## **4.7. Suspension of payment and bankruptcy of the debtor**

### *4.7.1. Types and scope of insolvency procedures*

Generally, a company is considered insolvent when it is no longer paying its debts. In some jurisdictions the mere fact that debts exceed the equity of the debtor may also lead to an insolvent position of the debtor.<sup>94</sup> An insolvency procedure may be initiated by debtors and/or creditors.

<sup>89</sup> Except in Switzerland under certain circumstances issuance stamp tax may be due (3.5).

<sup>90</sup> 3.5. and particularly appendix A.

<sup>91</sup> 3.4 and 6.2.

<sup>92</sup> 3.5.1.

<sup>93</sup> This also applies in certain in-court insolvency procedures (3.5 and 3.6).

<sup>94</sup> E.g. Austria, 3.6, Finland, 3.1.5, Spain, 3.4.

There appears to be no real harmonization of insolvency procedure rules,<sup>95</sup> even in the European Union, which recently introduced the European Insolvency Regulation (the regulation).<sup>96</sup> Therefore, the details of the relevant regimes will have to be examined on a country-by-country basis.<sup>97</sup>

All jurisdictions under review have at the minimum a classic insolvency procedure during which a court-appointed trustee in bankruptcy will liquidate all assets of the debtor and use the proceeds to pay creditors in proportion to their entitlement, taking into account preferences and security interests. The trustee manages the bankruptcy estate until all assets have been distributed or the court has homologated an arrangement with the creditors.

A bankruptcy procedure of a company may or may not lead to the liquidation of the company itself. In some jurisdictions the opening of a procedure already leads to liquidation.<sup>98</sup> If it does not, then in some jurisdictions the obligations of the debtor revive, in other jurisdictions the debtor can no longer be pursued for its obligations existing at the time it was declared bankrupt.

Procedures preceding a liquidation-focused procedure exist in some form or another in a number of jurisdictions (but not in all). Generally these aim to protect the debtor against creditors on a temporary basis, in order to allow the reorganization of the debtor's financial position in order to prevent bankruptcy.

The Chapter 11 (US Bankruptcy Code) procedure is particularly well known; it allows a protected voluntary reorganization. During this procedure, an automatic stay enters into force with exceptions for certain preferential and secured creditors. The debtor may commence a reorganization of its business, in principle under its own management. During the procedure the debtor may continue its business with certain restrictions in relation to the disposal of assets outside the ordinary course of business and the use of free cash. A committee of creditors is appointed to represent the interests of creditors and to negotiate a reorganization plan with the debtor. Essentially a reorganization plan must be voted on by a qualified majority of creditors in a relevant affected class of creditors and, if approved by the court, will be binding on all creditors in that class. If the reorganization is successful, the debtor will exit from Chapter 11 solvent and can continue its business. If a reorganization plan is rejected or fails, the debtor will

<sup>95</sup> Although attempts have been made, e.g. the UNCITRAL (United Nations Commission on International Trade Law) Model Law on Cross-Border Insolvency (1997), promoting uniform legislative provisions dealing with cross-border insolvency.

<sup>96</sup> The European Insolvency Regulation, European Union, Council Regulation (EC) no. 1346/2000 of 29 May 2000 on insolvency proceedings, OJ L 160, 30 June 2000, pp. 1–18, entered into force on 31 May 2002. The regulation mainly allocates jurisdiction in bankruptcy matters to the Member State in which the debtor's centre of main interest is located and provides for restrictions in other Member States where assets of the debtor are located (secondary proceedings). It also aims to provide creditors with more rights in lodging claims in other Member States and giving them better access to information on bankruptcy procedures. It does not harmonize – and therefore does not materially affect – Member States' domestic insolvency and bankruptcy procedures, which remain applicable to proceedings under their jurisdiction. The regulation does not contain tax provisions and as far as the reporters are aware no Member State has introduced specific tax rules as a result of the adoption of the regulation in its domestic tax legislation.

<sup>97</sup> For a summarized overview of relevant procedures see *Getting the deal through: Insolvency and Restructuring 2006*.

<sup>98</sup> E.g. Austria, 3.6, although tax liability remains until the liquidation process has ended.

enter into a regular bankruptcy proceeding, aimed at liquidating its assets and distributing the proceeds to the relevant creditors.

Similar types of reorganization proceedings exist in some of the other jurisdictions or are being introduced. In some jurisdictions during a regular bankruptcy procedure there is room for making a reorganization attempt.<sup>99</sup> In some jurisdictions, an agreement with a (qualified) majority of creditors is binding upon all creditors; in other jurisdictions a suspension of payment regime only protects the debtor for some time against claims from creditors, but leaves reaching a voluntary agreement with each and every creditor to the parties involved.<sup>100</sup>

There are also jurisdictions where a debtor can enter into voluntary negotiations with creditors, fully out of court, even outside insolvency situations, and then ask the court to agree a reorganization plan.<sup>101</sup>

#### 4.7.2. *Tax consequences of insolvency*

In most jurisdictions, a bankruptcy, administration or Chapter 11-type of procedure has no tax consequences as such for the debtor.

One exception is Denmark, which has a special tax regime for companies that are insolvent. Income received is only subject to tax if a positive (to some extent discretionary) decision is made to do so by the tax authorities. If so, then normal rules apply, with some beneficial rules on loss carry over. A special tax regime during bankruptcy also applies in Italy.<sup>102</sup>

Voluntary or forced amendments, waivers and conversions of existing indebtedness generally have the same tax consequences as discussed above.

A particularly relevant issue in situations involving a temporary stay (Chapter 11 or suspension of payment) is that in some jurisdictions deductibility of interest on an accrual basis is disallowed after a certain period of time or during bankruptcy. In those circumstances, interest is only deductible again when it is subsequently actually paid.

The cancelling of debt because the bankruptcy proceedings have ended, if covered by local law, is generally treated in the same way as a waiver for tax purposes. The timing of the recognition of this profit, and also the timing of disposals of assets in the context of an insolvency procedure, may be relevant for the amount of tax that actually will be paid due to the preference that tax claims may have before or during a bankruptcy procedure.<sup>103</sup>

In some jurisdictions certain rules advantageous to the debtor, such as exemption of waived debt, apply only if agreed during a formal insolvency procedure.<sup>104</sup>

<sup>99</sup> See Harris for a description of Chapter 11-like procedures available – or being introduced – in some European countries.

<sup>100</sup> E.g. the Netherlands suspension of payment procedure.

<sup>101</sup> E.g. Argentina, 3.6.

<sup>102</sup> Italy, 3.6.

<sup>103</sup> E.g. Netherlands, 3.6.

<sup>104</sup> E.g. Australia, 3.5; Chile, 3.6; Mexico, 3.6; Italy, 3.6; Japan: time limit on carry-forward of losses does not apply. Spain: exemption from capital tax in case of a debt-to-equity conversion approved by a bankruptcy court (3.6). UK: a waiver is not subject to a tax charge if the debtor has entered formal insolvency procedures (3.5). In the US, COD income during bankruptcy does not lead to taxable income, but only reduces tax attributes. During insolvency, the same

The US has a special “G-reorganization” tax regime that allows the debtor to transfer its assets with their high-tax basis to a new corporation largely owned by the former creditors of the the debtor.<sup>105</sup>

### 4.7.3. Tax residency consequences of the regulation

The UK report mentions that the regulation may have the effect that a non-UK resident company placed under this regulation in UK insolvency procedures may become tax resident in the UK. The reason is that the insolvency trustee/administrator manages the business in the UK.<sup>106</sup> This issue would occur because the relevant test in the regulation (centre of main interest) deviates from the management and control test and/or a treaty-based effective management test. Outside insolvency, tax residency would not be in the UK. The appointment of a UK trustee/administrator (and the fact that the managing director of the companies would no longer have effective powers because of the insolvency procedure) would then mean that management and control/effective management would have shifted to the UK.

This issue could arise in all EU Member States subject to the regulation, and also outside the EU to the extent that a trustee in bankruptcy managed the estate from another jurisdiction than the original tax residency state.

However, one could also argue that the residency determination for corporate entities implicitly assumes a certain permanence (if a board meets once or twice in another jurisdiction that does not immediately lead to a changed residency). In a relatively short-term reorganization or liquidation procedure, it is less likely that residency would be transferred permanently to another location, especially if, in the case of reorganization, the original management received its powers back immediately after the in-court reorganization procedure had finished (in this case management and its infrastructure would – latently perhaps – remain in place in the original jurisdiction of residence). There is also no intent to change residency.

In complicated and long-lasting insolvency procedures that take years, where the original local management and head office functions, etc., completely disappear and the only relevant remaining management tasks are with the administrator/trustee who is liquidating the business from the UK, the issue could, however, possibly arise.

## 4.8. Assignment of loan to another party

The assignment of a loan by one creditor to another creditor should not normally lead to any direct tax consequences for the debtor, since its indebtedness would remain unchanged. However, the status of the new creditor may affect its tax position in relation to this debt for the future; the new creditor may be a related party and this may lead to the application of thin capitalization rules,

*cont.*

applies to the extent the debtor is insolvent (3.6.2). Some additional favourable rules apply that are described in US, 3.6.4.

<sup>105</sup> US, 3.6.3.

<sup>106</sup> UK, 3.6.

non-deductibility rules, or to specific related-party rules on non-recognition of waivers. In the withholding tax area, domestic exemptions or treaty-based reductions may change.

Similar consequences may occur if previously unsecured third party debt is secured on the assets of a party related to the debtor, or is guaranteed by a party related to the debtor.<sup>107</sup>

In Australia and Canada, the assignment of an underperforming loan for less than the face value of the debt to a party related to the debtor is deemed to be a forgiveness of the debt for the amount that otherwise would have been forgiven (debt parking rules).<sup>108</sup> These “debt parking” rules aim to prevent avoiding debt forgiveness rules by assigning the loan to a related party and leaving it there. Similarly, in the US, the assignment to a party related to the debtor is considered a deemed exchange on the debtor’s level, leading to potential taxable income for the debtor.<sup>109</sup>

## 5. Creditor issues

### 5.1. General

Also on the creditor’s side the qualification of the relevant debt instrument for tax purposes and the consequences of the debtor and creditor being related to each other or in the same tax group need to precede any review of a debt restructuring.

Assuming that an instrument qualifies as a loan instrument for tax purposes and that the debtor and creditor are not in the same tax group, interest (and other) income realized on this instrument would normally be taxable income for the creditor.

With respect to losses and gains realized, differences occur based on the presence of a generic or “scheduler” corporate tax system. Some jurisdictions also distinguish between short-term and long-term holdings of loans for losses and gains realized on those loans.

In jurisdictions that have a participation exemption regime for qualifying shareholdings, specific legislative rules may apply to debt restructuring. These rules are generally aimed at avoiding a creditor taking a tax-deductible impairment loss on a loan instrument and subsequently realizing an exempt profit when the debtor’s business subsequently recovers and the creditor manages to receive a compensating benefit in some other way under the participation exemption. Generally, in those cases, the legislator attempts to ensure a recapture of the earlier deducted loss.

In the cross-border area, in some jurisdictions anti-abuse rules apply that try to prevent debtors’ losses being transferred to creditors or double losses being claimed, both on the debtor’s side and on the creditor’s side (i.e. leading to double non-taxation).

<sup>107</sup> A related party could also agree to be a co-obligor next to the debtor.

<sup>108</sup> Australia, 3.7; Canada, 3.7 and New Zealand, 3.7.

<sup>109</sup> 3.7 and 5.7.

## 5.2. Debtor unable to service the debt

### 5.2.1. Fair market value and commercial accounting

As soon as it becomes clear that the debtor will no longer be able to service the debt in the agreed way, the fair market value of the loan will decrease. The creditor will normally try to make an assessment of the likelihood that interest and principal will be received and if so, for what amount and in what time-frame.

In doing so a creditor will consider the (value of) the security it has, if any, the likely proceeds of an ultimate forced recovery of its loan or, ultimately, liquidation of the debtor, including what the collection costs would be and the time it will probably require to achieve repayment. It will determine whether late payment interest can be charged, either on a contractual or legal basis. In addition, currency exchange factors may play a role if the loan is denominated in a currency other than the functional currency in which the creditor prepares its accounts. These factors taken together will result in a fair market value of the loan, which is likely to be substantially lower than the nominal value of the loan in the case of a debtor in financial distress.

Normally, the creditor should continue to accrue the interest due under the loan. However, the likelihood that this interest would be actually paid and the time-frame in which that would occur, will have to be considered.

If the creditor has established a lower value than the nominal amount of the interest due and of the principal amount under the loan, the question arises whether the creditor could claim some form of tax relief taking into account the lower fair market value of principal and interest due (bad debt relief or impairment loss).

An important element of this in some jurisdictions (specifically those that apply commercial accounting as a basis for tax accounting, unless there are specific overriding tax rules), is the IAS-based valuation rules that apply to commercial accounts. It is likely that these rules will become more relevant in the future, as the use of IAS proliferates.

How a financial instrument is measured depends on the type of instrument and the purpose for holding that instrument;<sup>110</sup> every financial instrument must be categorized under these rules. Particular measurement requirements apply to each category. IAS 39 requires that a financial instrument, subsequent to its initial recognition, be measured for its fair market value if there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset.<sup>111</sup> The impairment loss is calculated as the difference between the asset's book value and the present value of estimated cashflows discounted at the relevant asset's original effective interest rate. If in the next financial year the impairment loss decreases again due to an event occurring after the initial impairment loss was determined, the previously recognized loss must be reversed through the profit and loss account.

<sup>110</sup> Financial assets at fair market value through profit and loss, available-for-sale financial assets, loans and receivables and held-to-maturity investments.

<sup>111</sup> Additionally, under IFRS 7 there are obligations to disclose financial exposures in relation to financial instruments, such as disclosure of credit risks.

## 5.2.2. Tax consequences

### 5.2.2.1. Interest income

Most corporate tax systems apply an accrual method. The creditor will therefore generally remain subject to tax on the amount of interest due under the loan agreement if the interest is not actually paid. This is irrespective of how the debtor treats the (unpaid) interest due or whether the agreement explicitly provides for capitalization of unpaid interest.

On the debtor's side, as we have seen, generally the debt remains unaffected and the debtor will continue to accrue interest due until the debtor is formally released from its obligations to pay, with certain specific exceptions. On the creditor's side, a more economic and less formal approach is generally applied, and the fair market value of the loan in case of impairment because of credit risks play a much more important role. As mentioned, the creditor will assess the value of the principal amount and of amounts of interest due.

The amount of interest due, for tax purposes, is generally treated as capitalized when it accrues. An impairment analysis will therefore normally<sup>112</sup> encompass both the principal amount of the loan and the accrued interest. However, Switzerland uses another methodology with similar effect: if payment of interest by the debtor is uncertain, profit recognition must be deferred until effective payment.<sup>113</sup> In the US, if there is no reasonable expectancy of payment of interest within the foreseeable future, then accrual of interest may cease.<sup>114</sup>

However, a number of countries have more formal rules under which a creditor may stop accruing interest income under certain conditions; generally including some timing requirements and requirements as to the start of legal proceedings. For example, this happens in Brazil and Japan,<sup>115</sup> and applies to Mexico for penalty interest.<sup>116</sup>

### 5.2.2.2. Amounts receivable

Most jurisdictions also allow some form of bad debt relief,<sup>117</sup> even if the impairment loss on the loan has not been realized. This usually applies on the condition that there has been a material decrease in the value of the loan because of the financial position of the debtor and the chances that full repayment will be received are significantly low. The bad debt relief mostly takes the form of an impairment of the loan or a specific provision. In the UK an impairment loss taken in the commercial accounts is automatically tax relieved,<sup>118</sup> subject to related-party rules.

<sup>112</sup> See for an exception Peru, 3.6 regarding financial institutions booking suspended interest.

<sup>113</sup> Switzerland, 5.1.

<sup>114</sup> US, 5.1.1.

<sup>115</sup> Japan, 5.1.

<sup>116</sup> 5.1.

<sup>117</sup> This term includes impairment loss, provision for doubtful debt, doubtful debt allowance and similar terms. Some jurisdictions distinguish between doubtful debt (limited deductibility) and bad debt (irrecoverable debt, full deduction). In this section this distinction is not made further, unless specifically mentioned.

<sup>118</sup> UK, 5.1.

Generally after an impairment loss has been taken, a subsequent increase in the fair market value of the loan leads to a profit for tax purposes, up to the original value of the loan in the creditor's books (recapture). Bad debt relief therefore normally forms a temporary relief as long as the loan is formally still outstanding and has a fair market value below the face value.

Some jurisdictions have generic systems allowing certain impairment losses on categories of debt, based on experience, statistical evidence or statutory rules: this is specifically true for financial institutions.<sup>119</sup> In most of these jurisdictions, relief is also available for specific bad debts or a separate category applies, allowing specific bad debt relief calculations, based on the actual position of the relevant debtor.

The burden of proof that the debt has become bad in all countries rests on the creditor. In some jurisdictions specific rules apply for proof either based on statutory provisions or on case law/administrative practice.<sup>120</sup> In Italy, although normally impairment losses are only deductible if the loss is "certain and precise", it appears that no such proof is necessary during a bankruptcy procedure of the debtor; it is then assumed that the debt is bad, even if there is a chance that payments will be made.<sup>121</sup> In Sri Lanka, the tax authorities have to consider an impairment loss reasonable and are unlikely to consider a loss as such in a related-party situation.<sup>122</sup>

There are also jurisdictions with more formal rules that allow bad debt relief only under strict conditions caused by specific events and for restricted amounts, irrespective of the fair market value of the loan.<sup>123</sup> Simple non-payment is then not sufficient to claim bad debt relief. South Africa distinguishes between bad debt relief (fully deductible in certain circumstances) and doubtful debt allowance (deductible only for 25 per cent). Doubtful debt allowances must be annually reversed and considered again. In some other jurisdictions, bad debt relief is available, but only when the debt is formally written off; that has as a consequence that between the moment the debtor starts defaulting and the moment write-off takes place, the creditor in principle continues to accrue interest that is fully taxable.<sup>124</sup> This applies also in India; additionally, if the receivable in question is secured, then write-off is only possible if the security has been realized or valued.<sup>125</sup> In some jurisdictions, bad debt relief is not available at all,

<sup>119</sup> E.g. Luxembourg, 4.

<sup>120</sup> E.g. Canada, 5.1, Mexico, 5.1, Norway, 4 and 5.1 (in Norway, it is possible that this proof is only available after a number of years; the branch report cites in section 5.5 a case where the required proof could be obtained only 15 years after a specific debt had been forgiven. Only then could the creditor deduct the loss).

<sup>121</sup> Italy, 4.1.

<sup>122</sup> Sri Lanka, 5.1.

<sup>123</sup> Argentina, 5.1, also Brazil, 5.1: effectively only when legal proceedings have started and with some threshold timing conditions. Japan has specific rules allowing bad debt relief upon certain events occurring and specifies the amount of the relief then available; Japan, 5.1; Spain, 5.1; Uruguay, 3.2.1.1; Korea, 5.5 (a long list of different situations in which bad debt is available under specific conditions).

<sup>124</sup> Australia, 5.1; although there is a practice that the tax authorities accept that interest no longer is taxable on an accrual basis but on a payment actually received basis, if certain strict conditions have been met. Belgium: only when the loss is real and definitive (Lamon and Chalot, p. 282).

<sup>125</sup> 4.2.1.

or only to certain type of taxpayers, such as financial institutions. In the latter case, in some countries the tax treatment is then coordinated with banking regulatory rules on valuation of bad debts.<sup>126</sup>

In schedular systems specific conditions may apply which relate to the schedule in which the bad debt relief is claimed. Generally, such a loss is only deductible against income in that same schedule. In South Africa, professional moneylenders can take a doubtful debt allowance as part of their ordinary income. However, other corporate taxpayers will realize a capital loss that is not deductible against ordinary income, but can only reduce the amount of taxable capital gains, unless the loss relates to a receivable that has been included in taxable profit of the taxpayer in the same or previous year (e.g. accrued interest).<sup>127</sup>

Exceptions as to the deductibility of bad debt relief apply to loans provided to related parties in, for instance, Brazil, Denmark, Finland,<sup>128</sup> New Zealand,<sup>129</sup> South Africa,<sup>130</sup> Spain<sup>131</sup> and the UK; and to loans provided to members of the same tax group (although, in the latter situation, account may be taken of the impairment losses for certain individual tax purposes).

### 5.2.2.3. Credit for withholding tax

If the interest is subject to withholding tax in the source state and the relevant tax treaty or domestic legislation provides for a credit to the creditor, then the issue arises as to how the credit interacts with the non-receipt of the interest and the bad debt relief that is taken on principal and interest due. Article 23B MTC does not prescribe a detailed method of relief. Any domestic method of providing relief is acceptable as long as the principle laid down in article 23B<sup>132</sup> is observed.

Logically, but also through the reference in article 23B(1) last sentence to the amount of attributable resident-state tax, credit should only be available in the tax year in which the relevant income is taxed in the residence state of the creditor. If the creditor accrues the interest income, the credit should therefore be granted, in principle, in the year of accrual.

In calculating the second limit,<sup>133</sup> the question is whether bad debt relief should be attributed to the interest income. It can be argued that this is not the case, because the question is whether bad debt relief is not directly allocable to the generation of the interest income as such. It results from a generic impairment of the amount outstanding on the particular debtor. The impairment loss

<sup>126</sup> E.g. Indonesia, 5.1; Mexico has a special regime for financial institutions next to a normal impairment regime for other taxpayers (5.1.1). See also Sri Lanka, where banking regulations rule tax deductibility (4). Also the US, where debts are presumed to be bad if the write-off was ordered/confirmed by regulatory authorities (5.1.2).

<sup>127</sup> 5.1.

<sup>128</sup> But only on loans and not on accounts receivable (3.2.1).

<sup>129</sup> Unless the debt is for the provision of goods and services by the creditor, or, in certain circumstances, the loan was made in the ordinary course of the business of the creditor (5.1).

<sup>130</sup> A loss realized by a creditor in a related-party situation is not accepted as a capital loss (5.1).

<sup>131</sup> Unless the related debtor is declared bankrupt (5.1).

<sup>132</sup> Commentary, para. 60.

<sup>133</sup> Art. 23B(1), last sentence, MTC.

could be taken in the year of the interest becoming due, but also in later years; the timing of the impairment loss on the amount of interest due should therefore not affect the creditor's entitlement to the credit.

### 5.3. Amendment of terms and conditions

As is the case on the debtor side, amending the terms and conditions of the loan may have an effect on the qualification of the instrument. This may be because of formal statutory rules. For example, an extension of maturity or the subordination of the loan may lead to a changed qualification for tax purposes. It may also be that in related-party situations the application of the arm's length test leads to the conclusion that an unrelated creditor would never have agreed to extend the payment terms, but would have called in the loan and recovered the amount due. Under those circumstances it may be considered that the creditor, by not calling in the loan, has not acted at arm's length.

The consequences of this may differ, depending on the exact relationship the creditor has with the debtor. If the creditor is the direct shareholder of the debtor, it may be effectively considered to have contributed the amount of the loan to the capital of the debtor. As an example, Japan has specific donation tax rules for those types of circumstances, limiting tax deductibility.<sup>134</sup> Any other amendment of the terms and conditions would have to be reviewed on its arm's length character. The main test would normally be whether the amendment of the terms and conditions could be fully explained from the change in the credit risk factor compared to the time the original loan was granted.

A material amendment of the terms and conditions may be considered as a novation of the existing loan into a new loan (see section 5.4). In countries that have strict rules on taking an impairment loss on a receivable, this may mean that the old debt is considered realized, so that a loss on that old debt can be taken, which would not necessarily be possible if the old debt were considered to continue.<sup>135</sup>

A renewed valuation of the outstanding amounts on the debtor should be made, taking into account the agreed amended terms and conditions. If the amendment has a positive effect on the valuation, this may lead to a mitigation of the impairment, and therefore limit the impairment loss in the same year, or to a partial recapture of an impairment loss taken in a previous year.

### 5.4. Refinancing the debt by new debt

If the same creditor agrees to provide a new loan to the same debtor and the old debt is repaid with the proceeds of the new loan, there are two relevant tax elements:

- (a) there is possible recognition on the old loan; and
- (b) the new loan has to be considered for its own tax consequences.

The first point would lead to realization of yet unrealized results, subject to roll-over rules allowing for relief, if any. There may be realization of foreign currency

<sup>134</sup> Japan, 5.2.2.

<sup>135</sup> E.g. Norway, 5.2.

exchange results. In jurisdictions with restrictive rules on impairment losses, refinancing through new debt will often allow a loss to be taken.

On the second point, the new loan would have to be qualified according to the comments made before and bad debt relief would have to be considered. In practice, it is likely that apart from an increase in the loan amount, the replacement of an old loan by a new loan will often not result in a materially different valuation of the loan from the creditor's perspective.

Under IAS, new debt, with new terms and conditions, may lead to a different valuation from the old debt. In countries where tax accounting follows commercial accounting, this may have a tax effect. Similarly, in the US detailed rules exist for the treatment of this type of exchange, potentially leading to taxable profit on differences in value. If the instruments involved qualify as securities, however, a rollover facility may apply.<sup>136</sup>

### 5.5. Conversion of debt into equity of the debtor

If the creditor agrees to convert an existing loan into the equity of the debtor and the old debt is considered cancelled as a result, there are two relevant tax elements:

- (a) there is possible recognition on the loan; and
- (b) the equity has to be considered for its own tax consequences.

The first point will lead to realization of yet unrealized results, as in the case of novation of the debt. For this, the key issue is at what value the shares will be recognized for tax purposes since this usually will determine the (deemed) proceeds of the conversion of the loan; this will also normally establish the tax basis of the shares obtained because of the conversion. This is particularly relevant when the tax treatment of the shares differs from that of the loan.

In a limited number of jurisdictions, the value of the shares received will be deemed equal to the nominal value of the debt,<sup>137</sup> so that no result will show on the conversion. In most jurisdictions, the tax basis of the shares received will be the fair market value of those shares; this applies even to some jurisdictions that on the debtor's side apply the face value theory. In the unlikely case that a positive result would arise, then in some jurisdictions roll-over relief is available (e.g. in the US in case of qualifying reorganizations).<sup>138</sup> In some jurisdictions, this relief is not available if debt is converted into equity, because this is not considered to be a similar type of asset.<sup>139</sup> In most cases, however, in the context of debt restructuring, it is more likely that a loss would appear on the debt results. Generally, the deductibility of this loss follows the same rules as exist for other realizations on debts.

In a jurisdiction with a schedular system the loss a creditor may realize upon conversion may be an effectively non-deductible capital loss, while impairment loss on a trading credit may be deductible. Taking a bad debt reduction before

<sup>136</sup> 5.2.3.

<sup>137</sup> See the extensive discussion in France, 2.4, but also India, 4.4 (a previously taken loss on the debt will be recaptured as a result of the conversion).

<sup>138</sup> 5.4.

<sup>139</sup> E.g. the Netherlands, 1, like-for-like roll-over relief.

conversion is then relevant in order to secure deductibility against ordinary income.<sup>140</sup> In some of those jurisdictions, there is also the issue whether the tax base of the original loan is carried over to the shares received in their place, or whether there is recognition of gain on the original loan. In Australia, there is a roll-over for these purposes.

Any further results compared to the tax basis so established will then be realized under the tax regime applicable to shares, which may include a full exemption on appreciation and other capital gains.<sup>141</sup> Italian law provides an interesting optional exception, allowing financial institutions not to apply the participation exemption regime, which allows them to take impairment losses on equity arising from converted debt, so that they can effectively continue writing off, but now also on shares, if circumstances so dictate.<sup>142</sup>

A specific point in case of debt-to-equity conversions arises in the possible recapture of earlier impairment losses. In most jurisdictions an earlier impairment loss on a loan, if allowable for tax purposes, generally has to be recaptured up to the original cost price of the loan (generally the nominal value) if that loan subsequently increases in value. This is because the financial position of the debtor becomes better; this normally requires the creditor to mark-to-market its receivable up to its original cost price. Taxpayers residing in jurisdictions that provide for a beneficial treatment of capital gains on shareholdings may consider a debt-to-equity conversion beneficial because it may be a way to avoid that recapture. If so, this is an important motivator for a creditor to agree to this type of conversion. Some governments allowing bad debt relief to creditors will want to have their part of the increase in value when the financial position of the debtor improves again and therefore in some jurisdictions specific (anti-abuse) rules exist.

In this area, substantial differences can be found between the various jurisdictions. This is caused by a number of factors:

- (a) the differences in the generic systems on the treatment of shareholdings: exemption or credit system;
- (b) the treatment of capital gains under such a system: in most credit systems, capital gains on shares are taxed; some jurisdictions apply a specific tax regime for capital gains<sup>143</sup> and in some jurisdictions capital gains on shares are included in the participation exemption system;
- (c) the presence of anti-abuse rules that aim to ensure that a previously taken impairment loss on a loan is recaptured and not avoided by claiming lower tax rates or full or partial exemption on the basis of beneficial rules dealing with capital gains on shares, as mentioned above;
- (d) the presence in domestic law of a revival instrument (conditional waiver)<sup>144</sup> and the tax treatment of it; if such an instrument exists and the proceeds of this instrument are taxed only when actually received, this provides for a more attractive solution to creditors than leaving a loan in place and having

<sup>140</sup> E.g. Sri Lanka, 5.4.

<sup>141</sup> E.g. Luxembourg, 5.4 and Switzerland, 5.4.

<sup>142</sup> Subject to specific conditions (5.4.2).

<sup>143</sup> E.g. South Africa (1) taxes effectively capital gains at half the normal corporate tax rate.

<sup>144</sup> See section 4.6.

to mark-to-market the loan as the debtor recuperates from its financial distress; and

(e) the presence of generic or specific roll-over facilities.

Comparing the branch reports, the full scale of possible treatment of future value appreciation is available: from full recapture at ordinary tax rates to full avoidance of recapture (through exemption of future gains on shares). In some countries, the exact tax treatment is uncertain.<sup>145</sup>

A creditor receiving shares in return for a loan may become a related party to the debtor for some purposes. If non-resident, it may also be considered to have become connected to the jurisdiction of the debtor, leading to non-resident taxation that it may not have had based on the granting of the loan.<sup>146</sup>

As mentioned in section 4.5, the conversion of debt into a convertible instrument in most jurisdictions does not lead to equity treatment of the instrument until conversion. In jurisdictions that apply an exemption system to capital gains on shares, or grant some other benefits to creditors in relation to shares, the issue is whether the conversion of the instrument into shares leads to a profit being realized by the debtor at that point in time for the difference between the fair market value of the shares received and the cost price of the convertible. In some jurisdictions, this is not the case (e.g. Germany, Luxembourg, Sweden).<sup>147</sup>

## 5.6. Waiver of debt (wholly or partially) or of interest due

Third parties are likely to waive a receivable on a debtor only if there is no reasonable expectation of collection and if there are no viable alternatives for compensation. In third party situations, where shareholder motives do not play a role, a loss caused by a waiver is a real loss that should be allowed for tax purposes.

However, in related-party situations, the difficulty is distinguishing between true third party creditor motives and shareholder motives. Most of these financial distress cases are not black and white. There may be a mix of motives.

Since an unconditional waiver of a loan to a related party in another jurisdiction can be used to transfer losses across borders, the tax authorities of the creditor country generally scrutinize these waivers even more closely. The exact tax treatment of waivers in related-party situations is therefore generally more uncertain; the interpretation of the arm's length test in these circumstances may give rise to discussions.

In order to avoid these discussions, some jurisdictions have decided not to allow losses at all in related-party situations through specific provisions.<sup>148</sup> Most of

<sup>145</sup> Norway, 5.4.

<sup>146</sup> Australia, 5.4.

<sup>147</sup> All, 5.4.

<sup>148</sup> E.g. in Sweden, deduction for losses as a result of a waiver of a loan to a related party are not available and also not in respect of a waiver for bona fide business reasons (5.5). In Italy, a waiver by a shareholder leads to capitalization of the loan on the shareholding by the creditor in the debtor; the taking of a loss is considered incompatible with the participation exemption regime (5.5); a waiver then leads only to possible tax results upon disposal of the shareholding in the debtor. In Brazil, a waiver is considered by law a non-deductible expense

these then also do not tax the debtor on the resulting profit. In some jurisdictions, a formal waiver of debt granted to a related party may also trigger direct application of rules enacted to prevent recapture avoidance.<sup>149</sup>

Other jurisdictions apply the arm's length approach in these circumstances. If a waiver between related parties would not be considered at arm's length, the deductibility of the resulting loss would be prohibited at the creditor's level (it would be seen as a capital contribution in the debtor) and therefore normally should not lead to taxable profit on the debtor's side (see section 4.6). The Japanese tax authorities have published an interesting list of criteria to judge the arm's length character of a waiver in the context of the Japanese donation tax that is well worth reading when judging the arm's length character of a waiver in related-party situations.<sup>150</sup>

As an intermediate solution between these two systems, some tax regimes reverse the burden of proof that the waiver was at arm's length in related-party situations. They refuse the loss, unless arm's length proof is provided.

Assuming the waiver is considered to be at arm's length, a full or partial unconditional waiver generally leads to finalizing the loss for the relevant amount. If the loan has been correctly impaired in the past, the waiver by itself should not lead to an additional loss. As a result of the waiver, the bad debt relief will then lose its temporary nature and convert into a final loss. In some jurisdictions with strict bad debt relief rules, a waiver does not necessarily lead to an additional loss.<sup>151</sup>

As with other capital losses in jurisdictions having a separate capital gains and losses system, a waiver may lead to a capital loss, which can only be used to offset capital gains.

As mentioned before, quite a number of countries know the concept of a conditional waiver (earlier in this report referred to as the revival instrument);<sup>152</sup> the loss can usually be fully taken at the time of the waiver. There is generally no obligation to value the revival instrument and in some cases only actual receipts on the instrument are taxable.

In some jurisdictions, it should be considered whether the waiver constitutes a "donation" which would be subject to specific rules on non-deductibility<sup>153</sup> or specific donation tax.<sup>154</sup> The determination does not appear to be materially different from an arm's length test: if it is established that there was a bona fide business reason to waive, there should not be a donation.

A rather surprising development in the withholding tax area is that a legislative proposal is pending in Indonesia to subject debt forgiveness by an Indonesian creditor to a foreign debtor to a 20 per cent withholding tax, although in

*cont.*

to the creditor because it is assumed to be unnecessary and not habitual to the creditor's business (3.5).

<sup>149</sup> E.g. the Netherlands, 5.4.

<sup>150</sup> Japan, 5.5.

<sup>151</sup> Argentina, 5.4, but also Australia, 5.5.

<sup>152</sup> See section 4.6.

<sup>153</sup> Japan, 1; Spain, 5.5.

<sup>154</sup> E.g. South Africa, 5.5.

treaty situations Indonesia normally should be prevented from levying this tax. The Indonesian creditor will then not only suffer a loss on the loan, but will also have to pay this withholding tax to the Indonesian tax authorities, with little chance of ever “withholding” the tax from its debtor.<sup>155</sup>

## 5.7. Suspension of payment and bankruptcy of the debtor

From a creditor’s perspective, suspension of payment has similar consequences to those described in section 5.2; generally, this will lead to an impairment loss and therefore bad debt relief, subject to restrictions applying for instance in related-party situations.

If, during a formal out-of-court, or a forced in-court, reorganization, a creditor’s loans are restructured, the consequences described above will normally apply in the same way as without this formal process.

The consequences of a formal bankruptcy depend on the character of bankruptcy under the domestic insolvency laws of the debtor. If the obligations of the debtor revive after the bankruptcy has finished, the creditor will have to value the remaining unpaid amount of the outstanding loan, taking into account the chances that the loan will ever be repaid. In those jurisdictions where either the bankrupt corporate debtor will cease to exist (forced liquidation), or where by operation of law it is freed from any remaining unpaid debt, the creditor will generally face the tax consequences similar to that of a full or partial waiver.

In most jurisdictions where bad debt relief under formal rules is allowed only in case of certain events, generally this relief can be claimed once the debtor is declared bankrupt, or when the court approves an agreement with creditors.<sup>156</sup>

In jurisdictions where proof of the insolvency of the debtor must be provided in order to claim relief, bankruptcy or a homologation is generally accepted as conclusive proof for these purposes. In Italy no proof of insolvency is necessary for write-offs during a bankruptcy procedure of the debtor; it is then assumed that the debt is bad, even if there is a chance that payments will be made. In certain countries (e.g. Japan and Spain), the creditor can cease interest accrual during a court-led insolvency procedure in respect of the debtor.<sup>157</sup> In cross-border situations, application of these rules may be problematic if the debtor’s jurisdiction does not have similar insolvency procedures as the creditor’s jurisdiction; interpretation issues may arise.<sup>158</sup>

Both these types of formal rules may influence creditors in deciding whether or not to participate in an out-of-court debt-restructuring regime. They will most likely prefer the in-court insolvency procedure so as to be able to claim tax-deductible losses<sup>159</sup> and this is not really conducive towards voluntary debt work-outs.

<sup>155</sup> Indonesia, 6.2.

<sup>156</sup> Argentina, 5.6.

<sup>157</sup> Japan, 5.6; Spain, 3.6; in Spain a loss on a related-party debt is only deductible in case of the debtor having been declared bankrupt.

<sup>158</sup> Japan, 6.2.

<sup>159</sup> E.g. Italy, 5.6.

## 5.8. Assignment of loan to another party

Assignment by the old creditor of a loan to another party (the new creditor) generally means profit recognition for the old creditor. An impairment loss usually becomes final. If the assignee is a related party, arm's length issues may arise. If the jurisdiction of the assignor has anti-abuse rules on impairment loss-taking or recapture, assignment to a related party may be treated as an attempt to circumvent these rules and trigger them. This may lead to an immediate recapture of previous losses<sup>160</sup> or a deemed exchange of debt on the debtor's level, leading to potential taxable income for the debtor.<sup>161</sup>

Mexico levies a withholding tax on the amount of the discount if an assignment of a loan is made to a foreign assignee at a discount.<sup>162</sup>

If the old creditor transfers the loan to a new creditor, including interest due but not yet paid, the new creditor should not be able to claim a credit for the withholding tax when it would actually receive the net interest payment. The payment made to it has lost its character as interest payment; the new creditor acquired a monetary claim on the debtor for a certain amount.

## 6. Debt restructuring in domestic situations

### 6.1. The principle of transaction neutrality

Corporate tax systems usually do not really focus on tax neutrality in financial transactions between taxpayers. However, in the context of debt restructuring one would generally expect at the minimum that tax rules would not unduly prevent economically desirable debt restructurings; tax legislators are of course free to consider facilitating debt restructurings to avoid more damaging bankruptcies.

At the very least, one would therefore expect that a deductible item for a creditor leads to a corresponding taxable item for the debtor and vice versa. The key corporate tax issue in debt restructurings is what happens when the debtor settles its obligation for less than the face value of its debt (summarized as a "waiver").<sup>163</sup>

In order to avoid a cash outflow for the debtor caused by a waiver leading to effective tax, it is important that the debtor can carry forward losses from previous years and may compensate the profit resulting from the waiver with those losses. Usually these losses are part of the financial distress and the waiver intends to ameliorate the debtor's financial position: previous losses and the waiver are therefore connected economically. Compensation of the debt forgiveness profit with these losses leads to a neutral tax effect of the debt restructuring on the debtor's level. The real economic loss is at the creditor's level and should

<sup>160</sup> In certain cases: the Netherlands, 5.7.

<sup>161</sup> US, 3.7 and 5.7.

<sup>162</sup> Mexico, 5.7.

<sup>163</sup> It may be for the full or for a part of the principal amount of the debt and it may take various legal forms.

therefore be tax deductible there. If this minimum position applies, tax issues will not hamper a debt restructuring.

If alternative approaches result in tax neutrality on the (domestic) transaction level, then this is in principle fine too. However, as we will see, tax neutrality will not usually result in cross-border situations if alternative approaches are chosen.

Deviations may lead to economic double taxation (and double tax revenue) or to economic double non-taxation (and loss of tax revenue) on the transaction.

Economic double taxation may negatively affect otherwise desirable debt restructurings. A creditor would be less inclined to waive a loan to a debtor in distress if it were unable to take the loss and the debtor would be burdened with an additional tax claim mitigating its intended financial improvement.

Economic double non-taxation may “subsidize” debt restructuring. This would occur if the creditor were allowed a tax deduction for its loss, while the debtor were granted an exemption for the corresponding profit and allowed to keep its tax losses and other tax attributes for future use. Legislators will want this double non-taxation to be intentional in order to avoid loss of revenue and will try to prevent, through strict conditions or anti-abuse rules, double non-taxation otherwise.

In a theoretically perfect system, these principles are also maintained on a timing basis, i.e. corresponding taxation occurs in the same tax year so that the tax impact is strictly neutral in cash value terms.

## **6.2. Tax regimes reviewed**

### *6.2.1. General*

Quite a few tax regimes described in the branch reports apply rules that lead to a result compatible with these principles in domestic situations, although the strict timing basis appears to be mostly ignored.

Any debt modification is generally to be considered in the context of recognition of profit/losses and (part) waiver of indebtedness. The differences in the various jurisdictions are broadly speaking whether this recognition is required in all or some forms of debt modification, the timing of it and the (final) treatment (including the valuation of the modification) of the overall profit for the debtor and the loss for the creditor. The outcome of the debt work-out in the various countries, both in terms of the final end-result and in timing terms, generally depends on the form chosen and the relevant tax status of the parties involved. Important differences can also be found in the area of loss carry-forwards, separate schedules in which income/expenses and capital gains/losses are treated and the availability of, and conditions for, exemptions for debtors on debt forgiveness profits.

### *6.2.2. Different approaches*

A limited number of tax regimes apply restrictive (often formal) rules on creditors being allowed to take a loss. These rules primarily aim at preventing artificial tax deductions and resulting loss transfers, but also have the effect that

deductibility of legitimate impairment losses is delayed; the loss can often only be taken when the debtor realizes the corresponding profit. The potentially undesirable effect of this is that creditors have an incentive to accelerate judicial procedures since that is often a condition of the tax deductibility of their loss. This may accelerate the financial distress of the debtor and may lead to bankruptcy more quickly. This type of rule is also not conducive to achieving non-judicial debt work-outs.

The majority of the tax regimes under review have more liberal rules; creditors are allowed to take a loss earlier than the debtor being taxed on the corresponding profit. This approach is compatible with economic and legal reality and the accounting principle of prudence: the creditor is allowed to take a tax deduction, when (and to the extent) it becomes clear that a debtor will be unable to pay. The relevant debtor realizes the profit only when it is legally released from its obligations. In these situations, there is ultimately tax neutrality between the creditor and the debtor. There is a timing difference, but this is not detrimental to debt restructuring.

Some jurisdictions intentionally exempt debtors from profits realized through debt waivers, usually under the conditions that the debtor is in a financial distress situation or that the waiver has been granted in the context of a debt restructuring operation. Often the exemption is available only on the amount of profit resulting after previous losses have been compensated. Alternatively, the exemption is structured in such a way that any tax losses available for carry forward (or other tax attributes) are reduced with the amount of the exempt profit. The result is the same: the debtor's losses (and/or other tax attributes) are gone and the excess profit is exempted. The creditor's right to tax deduction is normally not affected in these cases. The exemption is motivated by the desire not to impede debt restructurings. An interesting alternative is the Finnish approach to value the profit for the debtor on the fair market value of the debt and accept that losses remain available.

Complications usually arise in the case of debt restructurings between related parties, specifically in the area of waivers. Governments view these with suspicion because of their arm's length character.

There are two basic types of approach:

- (a) applying the arm's length test on each transaction (and usually extra scrutiny is applied in the case of waivers); or
- (b) providing for formal rules denying or delaying deductibility of impairment losses at the creditor's side.

Exceptionally these latter rules are also applied in unrelated party situations. As long as these two methods are applied consistently on the creditor's and debtor's side, tax neutrality remains for the transaction. However, this is normally only true for domestic situations.

Similar issues arise in case of requalification of debt for tax purposes. As long as requalification is consistently applied on both the creditor and debtor side, corresponding taxation will still result, but usually only in domestic scenarios.

There are jurisdictions that focus on combating abusive impairment losses on the creditor side (whether or not in related-party situations) in order to prevent artificial transfer of losses from debtors to creditors. If those countries do not accept the consequences on the debtor side by granting exemption for the corres-

ponding profit, this creates economic double taxation and this may lead to serious tax hurdles for debt restructuring. There are quite a few countries where this is the case in some types of restructuring.

The same issue applies to situations where private individuals are creditors; they are usually unable to take an impairment loss on their portfolio investments. This is inherent in the tax systems of most countries since portfolio investors are generally treated differently from entrepreneurs.

An important problem for debt restructuring is the debtor actually being taxed on debt forgiveness profit. This occurs if and to the extent that the debtor cannot compensate a profit recognized in a restructuring with losses from the same or earlier tax years. This may be caused by:

- (a) time limitations applicable on carry-forward of losses;
- (b) certain type of losses, although actually being realized, not being tax deductible;
- (c) losses that are no longer available as a result of change of control or other anti-abuse rules that deny loss carry-forward to prevent loss trading;
- (d) a minimum tax that is always payable on annual profits before compensation of losses, either in the form of an alternative minimum tax or in the form of a relative limitation to compensation of previous losses with current profits; or
- (e) losses and profits being considered in different categories and the absence of compensation between categories.

Some legislators have lifted these restrictive rules in the case of qualifying debt restructurings. This then provides to some extent an alternative to an exemption of excess debt forgiveness profits. It may also lead to an additional incentive for debt restructurings.

### 6.2.3. *Other taxes*

Outside the corporate tax area, hurdles for debt restructuring can be found in formal VAT recovery rules that have timing impact on debt restructuring and stamp taxes applicable on certain forms of transactions. In some jurisdictions, these rules are perceived to create hurdles, but they do not appear to be prohibitive for debt restructuring.

## 7. Debt restructuring in cross-border situations

If within a jurisdiction the principles expressed in section 6.1 are followed, debt restructuring should not be hampered by tax rules. This also holds true if these principles are applied in the same way by the jurisdictions involved in a cross-border debt restructuring. However, when jurisdictions are involved that do not apply these principles or where different jurisdictions apply different principles asymmetries will arise that create tax hurdles.

As mentioned above, most countries appear to have a tax regime that is symmetrical for debtor and creditor domestically. However, they rarely take into account whether that regime is also symmetrical in cross-border situations. As

the economy globalizes, it seems sensible for legislators to consider the international tax aspects when substantially deviating from the principles discussed in section 6.1.

Where the deviation is beneficial to the debtor, it is not an issue for the debt restructuring. There is then often economic double non-taxation, but this is normally intended by the debtor's jurisdiction and applying this also in cross-border situations is logical and non-discriminatory from the debtor jurisdiction's point of view. If the debtor is unable to compensate a debt restructuring profit with earlier losses, this applies to domestic and cross-border situations alike. The remedy lies in changing the domestic rules. If the creditor is unable to deduct an impairment loss, the same applies.

Asymmetrical treatment in cross-border situations is a major source of tax issues and often is a real problem in debt restructurings within groups of companies.

These asymmetries may be caused by the presence of specific related-party rules. If both jurisdictions have such rules, there may be differences in the related-party criteria (third-party work-out in one jurisdiction but related-party work-out in the other jurisdiction). If they do not have specific related-party rules, differences in the interpretation of arm's length tests may cause problems.

Often specific issues in cross-border situations appear to be caused by specific related-party rules denying impairment losses for creditors (and normally exempting debtor profits). While symmetrical in domestic situations, they lead to asymmetries in cross-border situations. To the extent the debtor is not taxable under those related-party rules, this is a tax revenue issue for the debtor jurisdiction and not a tax issue that hampers debt restructuring. Excluding the debtor from this exemption because the creditor is resident abroad would cause non-discrimination issues. An interesting approach in this area is taken by Denmark, which conditions the exemption for a Danish debtor on the foreign (related) creditor not being entitled to an impairment loss deduction under Danish rules.

To the extent that the creditor is not able to take an impairment loss, this causes an issue with debt restructuring if the debtor, subject to tax in another jurisdiction, is effectively taxed on the corresponding profit. The issue is really whether a creditor would normally, in a domestic scenario, expect the debtor not to be taxed. A remedy would be to allow the creditor an impairment loss (and therefore make an exception to the related-party rules) when the debtor in the other jurisdiction is effectively taxed (the Netherlands applies this to some extent in certain circumstances).

Differences in qualification of debt also create problems: one jurisdiction considering a specific instrument as debt, while the other jurisdiction considers that instrument equity for its tax purposes. These qualification differences can be caused again by:

- (a) different conditions under which arm's length rules apply and/or differences in the interpretation of arm's length principles on the same debt instrument; and
- (b) formal requalification rules (e.g. hybrid debt rules).

In paragraph (a) situations, double economic taxation can occur. By applying article 9(2) (corresponding adjustment) and article 25 MTC (mutual agreement

procedure), the tax authorities of the relevant countries should in theory be able to resolve this.

Under current treaty rules, there is not really a solution for paragraph (b) situations. Jurisdictions legislating these formal requalification rules effectively denying creditors deductibility of impairment losses should consider whether an exception can be made for loans granted to debtors in other jurisdictions if the instrument is qualified differently there.

From an international perspective it seems better to combat abusive impairment losses on related-party debt through the arm's length approach rather than through formal rules. Achieving a balanced solution in a concrete case is much more difficult in the case of conflicting legislative provisions. In domestic situations legislators will consider explicit legislative provisions to be probably more efficient and less prone to abuse; internationally, they may fear cross-border loss importation. A compromise could be considered by including specific provisions in these rules for cross-border situations if asymmetries arise. Those provisions could be conditional upon there not being an apparent case of abusive loss transfer.

In addition to the non-corporate tax hurdles that also apply in domestic situations, there may be some interest withholding tax issues in cross-border debt restructuring, such as the deemed payment of interest caused by certain debt modifications and the changed tax status of a creditor that may have an impact on the level of interest withholding tax. Exceptionally (e.g. Indonesia), specific withholding taxes are imposed on the portion of debt that is forgiven cross-border. Such an extraordinary withholding tax would probably translate into an additional tax charge borne by the creditor and in that way would unduly burden debt work-outs.

## 8. Conclusions

Although the methods for reaching tax neutrality between debtor and creditor differ, most tax regimes described in the branch reports apply rules that lead to a more or less balanced result for the taxation of debt restructurings in domestic situations. The number of jurisdictions where there is a final asymmetrical tax treatment for debtors and creditors is limited. Such asymmetry usually results because the creditor is not allowed to take an impairment loss while the debtor is effectively fully taxed. Mostly, this occurs in related-party situations. These asymmetries provide a hurdle in achieving successful debt restructuring.

It is clear from the branch reports that legislators pay less attention to the consequences of cross-border tax restructuring. Because domestic tax regimes are different to each other, asymmetrical situations occur much more frequently in cross-border debt restructurings. This is a particularly material issue if creditor and debtor belong to the same group of companies.

These international asymmetries are mostly caused by different applications of arm's length tests and by specific related-party or debt requalification rules being applicable in only one of the relevant jurisdictions. If jurisdictions legislate these specific rules, they should consider making those rules not only consistent and symmetrical in domestic situations, but also internationally. As long as there

is no effective international coordination of tax regimes in this area, they should for instance consider making exceptions to rules denying creditors taking an impairment loss if the debtor in the other jurisdiction is effectively taxed on the corresponding profit, so that economically desirable debt restructurings are not hampered by these asymmetries.

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### Summary

The general report provides an overview of the various ways in which jurisdictions approach the tax treatment of debt restructuring. The branch reports look at these issues by following the developments in the relationship between debtor and creditor, from a normal non-defaulting loan, through default, leading to a debt restructuring situation, and, in a worst-case scenario, bankruptcy. Although corporate tax systems do not normally focus on tax neutrality in financial transactions, at the very least one would expect a deductible item for a creditor to lead to a corresponding taxable item for the debtor, and vice versa. If not, double economic taxation or non-taxation could arise, seriously hampering or subsidizing debt restructuring.

Quite a few tax regimes result in a tax-neutral approach in domestic situations, although mostly not in timing terms. A limited number of tax regimes apply restrictive, often formal rules, on creditors not being allowed to take a loss, mostly aimed at preventing artificial tax deductions and resulting loss transfers. Apart from delaying deductibility of legitimate impairment losses, the undesirable effect may be that creditors have a tax incentive to accelerate judicial procedures against the debtor, potentially increasing its financial distress.

The majority of the tax regimes, however, have more liberal rules on creditors taking impairment losses. The debtor is normally taxed on the profit resulting from being released from its obligations. Some jurisdictions exempt debtors on such profits in order to facilitate debt work-outs, usually, but not always, under cancellation of available loss carry-forwards and other tax attributes.

Debtors may also be taxed on the debt forgiveness profit and not be able to use losses incurred in the past, as a result of time limitations, separate treatment of certain types of losses and debt forgiveness profits, cancellation of losses in case of change of control, or minimum tax rules. Without profit exemption rules this may also cause tax hurdles for debt restructurings.

Complications arise in the case of debt restructuring between related parties, especially in the area of waivers. There are two basic types of approach: (a) applying an arm’s length test on each transaction and (b) providing for formal rules denying or delaying deductibility of impairment losses on the creditor side. As long as the debtor is not taxed on the corresponding profit, the system is in balance. Some jurisdictions, however, still tax the debtor, and this results in double economic taxation, hampering domestic debt restructuring.

In the absence of harmonization in the international area, cross-border debt restructuring may more often lead to economic double taxation. This is caused by two or more domestic

tax systems applying different rules on debt restructuring; even if these systems lead to symmetrical tax treatment in domestic situations, cross-border the combined effects of both systems may well be asymmetrical. Asymmetrical treatment in cross-border situations is a major source of tax issues and is often a real problem in debt restructuring within groups of companies. In related-party situations these issues are often caused by formal rules applying in one jurisdiction, denying losses for creditors, while the other jurisdiction applies arm's length tests, and may tax the debtor's corresponding profit. Double economic non-taxation may occur in the reverse situation. Differences in debt qualification (hybrid debt rules) cross-border may also cause such asymmetries.

Generally, formal rules denying creditor losses are more likely to lead to tax hurdles in cross-border debt restructuring than the application of arm's length tests, although inconsistent application of these tests by the jurisdictions concerned may have the same effect.

